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Illustrations of accounting and reporting by development stage enterprises : a survey of the application of FASB statement no. 7; Financial report survey, 27

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FINANCIAL REPORT SURVEY 27

Illustrations of Accounting and Reporting by Development Stage Enterprises

A survey of the application of FASB Statement No. 7

By Hortense Goodman, CPA
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Illustrations of Accounting and Reporting by Development Stage Enterprises

A survey of the application of FASB Statement No. 7

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

NOTICE TO READERS

This is a publication of the staff of the American Institute of Certified Public Accountants and is not to be regarded as an official pronouncement of the Institute.

PREFACE

This publication is the twenty-seventh in a series produced by the Institute's staff through use of the Institute's National Automated Accounting Research System (NAARS). Earlier publications in the series are listed on the inside cover of this publication.

The purpose of the series is to provide interested readers with examples of the application of technical pronouncements. It is believed that those who are confronted with problems in the application of pronouncements can benefit from seeing how others apply them in practice.

It is the intention to publish periodically similar compilations of information of current interest dealing with aspects of financial reporting.

The examples presented were selected from over eight thousand annual reports stored in the NAARS computer data base.

This compilation presents only a limited number of examples and is not intended to encompass all aspects of the application of the pronouncements covered in this survey. Individuals with special application problems not illustrated in the survey may arrange for special computer searches of the NAARS data banks by contacting the Institute.

The views expressed are solely those of the staff.

George Dick
Director, Technical Information Division

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I

SCOPE AND PURPOSE OF THE SURVEY

NATURE OF DEVELOPMENT STAGE ENTERPRISES

An enterprise is in the development stage if it is devoting substantially all its efforts to establishing a new business. Planned principal operations have either not commenced or, if they have commenced, the revenue from them has not been significant. Some of the activities to which the enterprise is devoting its efforts may include financial planning, research and development, and starting up production.

In June 1975 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 7, "Accounting and Reporting for Development Stage Enterprises." Statement No. 7 specifies the manner in which development stage enterprises should account for assets, liabilities, revenue, and expenses, and the financial information that they should report.

Statement No. 7 is reproduced in the appendix to this survey.

SOURCE OF ILLUSTRATIONS

Accounting and reporting for development stage enterprises in accordance with Statement No. 7 requires considerable judgment. An accountant who is confronted with problems in applying the Statement can benefit from learning how other accountants are applying it in practice. Accordingly, this publication presents the recently published financial statements of selected development stage enterprises that illustrate its application.

Development stage enterprises also present problems to independent accountants who are engaged to examine their financial statements. In reporting on the financial statements of any type of enterprise, the independent accountant who has examined the statements must consider whether there is substantial doubt about the enterprise's ability to continue in existence and, if so, must modify his report accordingly. The consideration is especially important as it applies to a development stage enterprise because of the enterprise's lack of operating experience. Accordingly, the reports of the independent accountants on the financial statements of the development stage enterprises included in this publication are presented with the statements.

The AICPA National Automated Accounting Research System (NAARS) was used to compile the information. The 16 examples presented were selected from more than 8,000 published annual reports to stockholders stored in the computer data base.

II

NONOPERATING DEVELOPMENT STAGE ENTERPRISES

Statement No. 7 requires development stage enterprises to present the same three basic financial statements as established operating enterprises. It requires development stage enterprises to recognize revenue in the same manner as it is recognized by established operating enterprises. It requires development stage enterprises to capitalize or defer costs subject to the same assessment of recoverability that is applicable to established operating enterprises. It requires development stage enterprises to disclose types of information that are not disclosed by established operating enterprises.

Nine examples of development stage enterprises that apparently have not commenced planned principal operations are presented below. The only basic financial statement presented by four enterprises was the balance sheet, but those enterprises had no revenue or expenses to report in an income statement. Six enterprises presented the three basic statements. The examples are classified according to whether or not the independent accountant expressed an opinion with a "subject to" qualification.

OPINION WITH "SUBJECT TO" QUALIFICATION

AL MASANE PROJECT
Balance Sheets
(A Venture in the Development Stage)

December 31, 1982 and 1981

Assets	1982	1981
Current Assets:		
Cash	$ 4	$ 3
Advances to engineering consultants	—	29
Inventory	271	271
Total current assets	276	304
Deferred Development Costs (Notes 1, 2, and 3)	16,324	14,887
Total	$16,600	$15,191

Liabilities		
Current Liabilities:		
Accounts payable and other liabilities	$ 145	$ 137
Loan Payable (Note 3)	11,000	11,000
Deferred Capital Contribution (Note 4)	580	580
Venturers' Capital (Notes 1 and 5)	4,875	3,473
Total	$16,600	$15,191

See Notes to Balance Sheets.

Notes to Balance Sheets

(A Venture in the Development Stage)

December 31, 1982 and 1981

1. Accounting Policies and Other Matters

Operations—Arabian Shield Development Company ("ASDC"), a United States corporation, and National Mining Company ("NMC"), a limited liability company formed pursuant to the Companies Regulations of Saudi Arabia, (the "Venturers") have been granted a license from the Saudi Arabian Government (the "Government") to explore and develop mineral deposits in the Al Masane area, located in the Asir Province of Saudi Arabia. This license by its terms has expired; however, the license has been orally extended for so long as mineral exploration is conducted. During 1978, the Venturers commenced a mining feasibility study to determine the amount of mineral reserves in the license area. This study is referred to as the Al Masane Project (the "Project"). The operations of the Project are separate and distinct from the other operations of ASDC in Saudi Arabia. Exploration costs in the Al Masane area prior to commencement of this development phase have been expended by ASDC and are not reflected in these financial statements.

In connection with this mining feasibility study, ASDC entered into an agreement, effective September 1, 1978, with Watts, Griffis and McOuat Limited, consulting engineers, to provide management, supervision and consulting services to the Project. In addition, the Venturers received an $11,000,000 interest-free loan from the Government in order to finance the study (see Note 3).

In October 1980, ASDC entered into an agreement with Watts, Griffis and McOuat Limited and SNC Corporation to conduct a full bank feasibility study of the Project. The feasibility study, which was completed in August 1982, concluded that the Project would support commercial production for approximately nine years. Management of the Company believes that exploration conducted subsequent to the completion of the feasibility study supports commercial production for an additional six years (see Note 3).

Inventory—Inventory consists of the estimated unused balance of spare parts and supplies necessary for maintenance of property and equipment and is stated at average costs. Usage is charged to deferred development costs as material and maintenance costs until such time as commercial operations commence.

Deferred Development Costs—All costs, including the cost of property and equipment, relating to the general organization of the Project and other costs not specifically attributable to the construction of the property and equipment are deferred until such time as (1) the Venturers can commence successful exploitation of the related mineral deposit, at which time the costs will be transferred to property and depleted, or (2) the Project is abandoned, at which time the Project's costs will be written off.

Translation of Currencies—The financial statements of the Project are stated in U.S. dollars. For purposes of these financial statements, all transactions in other currencies were translated at the rate in effect at the time the transaction occurred.

Fees—Watts, Griffis and McOuat Limited has been paid $1,896,212 for various management and professional services through December 31, 1982. These fees have been allocated to deferred development costs based on management estimates of the work performed.

2. Deferred Development Costs

Deferred development costs at December 31, consisted of the following:

	1982	1981
Property and equipment:		
Mining equipment	$ 2,247,072	$ 2,247,072
Mobilization and construction	1,487,113	1,471,041
Camp and equipment	1,257,587	1,254,533
Portalling	236,819	236,819
Diamond drilling bits	228,385	228,385
Explosives storage facilities	55,034	55,034
	5,512,010	5,492,884
Other:		
Materials and maintenance	3,649,628	3,546,356
Wages and benefits	3,930,207	3,519,822
General and administrative	1,600,715	1,296,347
Transportation of labor	395,705	363,431
Feasibility study	1,235,926	668,577
	10,812,181	9,394,533
Total	$16,324,191	$14,887,417

3. Loan Payable

To finance the development phase of the Project, ASDC and NMC jointly obtained an interest-free loan of $11,000,000 from the Saudi Arabian Ministry of Finance and National Economy in an agreement dated January 24, 1979. The loan is to be repaid in 10 equal annual installments commencing in January 1984.

The Government has the option to participate in the proceeds of any mineral exploitation by acquiring one-half of NMC's interest through its official mining and petroleum company, Petromin. In the event that the Government wishes to exercise its right to participate, the $11,000,000 loan will be considered as part of its participation in the capital of the Project. All of the Project's assets are pledged as collateral to the loan.

Based on the August 1982 feasibility study and subsequent exploration of the Project discussed in Note 1, ASDC and NMC are jointly attempting to obtain a $105,000,000 interest-free loan from the Saudi Arabian Government. The proceeds of the loan would be used to construct a 1,500 ton per day mining and milling complex.

4. Deferred Capital Contribution

In accordance with agreements between ASDC and NMC, NMC will fund 50% of the Project's exploration costs if the exploration license is converted to an exploitation license. NMC had advanced the Project $580,000 as of December 31, 1982 for exploration costs. Since NMC has no liability for exploration cost unless the exploration license is converted to an exploitation license, the advance has been classified as a deferred capital contribution.

5. Venturers' Capital

Venturers' capital at December 31, 1982 and 1981 consisted solely of contributions by ASDC.

Auditors' Opinion

The Board of Directors
Arabian Shield Development Company
and National Mining Company:

We have examined the balance sheets of the Al Masane Project (a Venture in the development stage) as of December 31, 1982 and 1981 (expressed in U.S. dollars). Our examinations were made in accordance with auditing standards generally accepted in the United States of America and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note 1, a substantial portion of the total assets of the Project is represented by deferred development costs. The Project was not being commercially operated as of December 31, 1982 and additional expenditures will be necessary before commercial operations, if any, are commenced. The ultimate recoverability of the deferred development costs cannot presently be determined.

In our opinion, subject to the effects on the balance sheets of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the accompanying balance sheets present fairly the financial position of the Al Masane Project at December 31, 1982 and 1981, in conformity with accounting principles generally accepted in the United States of America applied on a consistent basis.

March 28, 1983

ALFACELL CORPORATION
Balance Sheet
July 31, 1983 and 1982

Assets

	1983	1982
Current assets		
Cash	$ 1,085	$ 1,900
Cash equivalents	966,696	—
Cash in bank trustee (Note 5)	—	80,622
Sundry receivables and prepaid expenses	5,019	—
Total current assets	972,800	82,522
Equipment, net (Notes 1, 2, 4, 5, and 8)	329,178	113,437
Other assets		
Security deposits	16,346	—
Deferred charges (Notes 1 and 3)	7,817	16,865
Total other assets	24,163	16,865
Total assets	$1,326,141	$ 212,824

Liabilities and Stockholders' Equity

	1983	1982
Current liabilities		
Current portion of long-term debt	$ 11,960	—
Current portion of obligations under capital leases	18,375	—
Accounts payable	33,702	4,896
Accrued expenses	27,121	2,214
Total current liabilities	91,158	7,110
Long-term debt (Note 4)	25,932	—
Obligations under capital leases (Note 8)	84,840	—
Stockholders' equity (Notes 5, 7 and 9)		
Common stock $.001 par value; 15,000,000 shares authorized, 2,007,325 and 1,266,964 shares issued and outstanding	2,007	1,267
Capital in excess of par value	1,802,384	325,933
Deficit accumulated during development stage (Note 1)	(680,180)	(121,486)
Total stockholders' equity	1,124,211	205,714
Total liabilities and stockholders' equity	$1,326,141	$ 212,824

The accompanying notes are an integral part of these financial statements.

Statement of Operations

	Year ended July 31, 1983	Inception August 24, 1981 to July 31, 1982	Inception August 24, 1981 to July 31, 1983
Income			
Interest income	$ 43,564	$ —	$ 43,564
Preoperative expenses			
Research and development	77,292	102,559	179,851
Officers' salaries	64,500	4,000	68,500
Other salaries	55,868	—	55,868
Consulting fees	113,836	—	113,836
Payroll taxes	19,063	714	19,777
Laboratory supplies	63,593	—	63,593
Rent	51,000	—	51,000
Depreciation and amortization	36,184	1,553	37,737
Interest	21,283	—	21,283
Professional fees	20,842	1,500	22,342
Travel and entertainment	24,746	2,965	27,711
Office expenses	12,325	2,020	14,345
Other	41,726	6,175	47,901
Total preoperative expenses	602,258	121,486	723,744
Net loss	$ (558,694)	$ (121,486)	$ (680,180)
Loss per common share (Note 1)	$ (.34)	$ (.11)	$ (.48)
Average number of shares outstanding (Note 1)	1,661,832	1,155,194	1,416,089

The accompanying notes are an integral part of these financial statements.

Statement of Stockholders' Equity

From Inception, August 24, 1981 to July 31, 1982 and for the Year Ended July 31, 1983

	Common Shares Number of shares	Common Shares Amount	Capital in excess of par value	(Deficit)	Total stockholders' equity
Sale of shares	82,143	$ 82	$ 114,918	$ —	$ 115,000
Issuance of shares for equipment, research and development, and expense reimbursement	712,500	713	212,987	—	213,700
Issuance of shares for legal services	50,000	50	4,950	—	5,000
Cost of private offering	—	—	(6,500)	—	(6,500)
Adjustment for three-for-two stock split declared September 8, 1982	422,321	422	(422)	—	—
Net loss	—	—	—	(121,486)	(121,486)
Balance at July 31, 1982	1,266,964	1,267	325,933	(121,486)	205,714
Sale of shares in public offering	660,000	660	1,649,340	—	1,650,000
Costs of public offerings	—	—	(341,554)	—	(341,554)
Sale of shares to private investors	44,196	44	41,206	—	41,250
Exercise of warrants	1,165	1	3,494	—	3,495
Issuance of shares for equipment	15,000	15	13,985	—	14,000
Issuance of shares under stock grant program	20,000	20	109,980	—	110,000
Net loss	—	—	—	(558,694)	(558,694)
Balance at July 31, 1983	2,007,325	$2,007	$1,802,384	$ (680,180)	$1,124,211

The accompanying notes are an integral part of these financial statements.

Statement of Changes in Financial Position

	Year ended July 31, 1983	Inception August 24, 1981 to July 31, 1982	Inception August 24, 1981 to July 31, 1983
Sources of working capital			
Issuance of capital stock	$1,818,745	$ 333,700	$2,152,445
Decrease in deferred charges	11,700	—	11,700
Increase in long-term debt	69,924	—	69,924
Increase in obligations under capital leases	109,971	—	109,971
Total sources of working capital	2,010,340	333,700	2,344,040
Application of working capital			
Operations			
Net loss	558,694	121,486	680,180
Items not requiring outlay of working capital			
Depreciation and amortization	(36,184)	(1,553)	(37,737)
Working capital applied to operations	522,510	119,933	642,443
Purchase of equipment	250,777	114,417	365,194
Costs of offerings	341,554	6,500	348,054
Increase in deferred charges	3,800	17,438	21,238
Increase in security deposits	16,346	—	16,346
Reduce long-term debt	43,992	—	43,992
Reduce obligations under capital leases	25,131	—	25,131
Total applications of working capital	1,204,110	258,288	1,462,398
Increase in working capital	$ 806,230	$ 75,412	$ 881,642
Summary of changes in working capital			
Increase (decrease) in current assets			
Cash in bank	$ (815)	$ 1,900	$ 1,085
Cash equivalents	966,696	—	966,696
Cash in bank trustee	(80,622)	80,622	—
Sundry receivables and prepaid expenses	5,019	—	5,019
	890,278	82,522	972,800
Increase in current liabilities			
Current portion of long-term debt	11,960	—	11,960
Current portion of obligations under capital leases	18,375	—	18,375
Accounts payable	28,806	4,896	33,702
Accrued expenses	24,907	2,214	27,121
	84,048	7,110	91,158
Increase in working capital	$ 806,230	$ 75,412	$ 881,642

The accompanying notes are an integral part of these financial statements.

Notes to Financial Statements

July 31, 1983 and 1982

Note 1—Summary of Significant Accounting Policies

a. Organization

Alfacell Corporation (a Development Stage Company) was incorporated in Delaware on August 24, 1981 for the purpose of engaging in the research, development, production and marketing of various biomedical agents (primarily a purified anti-tumor agent) and the marketing of a range of biological products for sale to universities, private industry, research institutions and government agencies in the biomedical field. To date, the Company is in the initial stage of its operations and has not yet engaged in any commercial activities.

The Company is a Development Stage Company as defined in Financial Accounting Standards Board Statement No. 7. The Company is devoting substantially all of its present efforts to establishing a new business and its planned principal operations have not commenced and, accordingly, no revenue has been derived therefrom.

b. Equipment

Equipment is stated at cost. Maintenance, repairs and minor renewals are expensed as incurred. When property is retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts and any gain or loss on the disposition is reflected in operations. Depreciation is provided by the straight-line method over the shorter of estimated useful lives or lease terms.

The estimated useful lives are as follows:

Laboratory equipment	5-10 years
Office equipment	5-7 years
Automotive equipment	3 years

c. Deferred Charges

Organizational costs

Costs incurred in organizing the Company are being amortized over a sixty-month period.

Registration costs

Costs in connection with the public offering will be charged against the proceeds of the public offering.

Patents

Patent costs are deferred pending the outcome of patent applications. Successful patent costs are to be amortized using the straight-line method over periods of seventeen years. Unsuccessful patent costs are expensed when determined worthless.

d. Research and Development

Research and development costs are expensed as incurred.

e. Investment Tax Credits

Investment tax credits are accounted for under the "flow-through" method as a reduction of income taxes in the year they are utilized.

f. Loss Per Common Share

Loss per common share is based on the weighted average number of shares issued and outstanding during the period.

Loss per share and weighted average number of shares issued and outstanding data have been restated to reflect the three-for-two stock split declared September 8, 1982.

g. Reclassifications

The July 31, 1982 financial statements have been reclassified to conform to the 1983 presentation.

Note 2—Equipment

Equipment is summarized as follows:

	1983	1982
Laboratory equipment	$305,673	$110,617
Office equipment	14,219	3,800
Automotive equipment	45,302	—
	365,194	114,417
Less accumulated depreciation	36,016	980
	$329,178	$113,437

Note 3—Deferred Charges

Deferred charges net of accumulated amortization of $1,721 and $573, respectively, are summarized as follows:

	1983	1982
Organizational costs	$ 4,017	$ 5,165
Patent costs	3,800	—
Registration costs	—	11,700
	$ 7,817	$ 16,865

Note 4—Long-term Debt

Long-term debt consists of the following:

	1983
Note Payable—National Community Bank, payable in monthly installments of $710 plus interest at 1% over prime, secured by automotive equipment	$ 23,418
Notes payable—General Motors Acceptance Corp., payable in monthly installments of $415 including interest at 11.9% secured by automotive equipment	14,474
	37,892
Less current portion	11,960
	$ 25,932

Future maturities of long-term debt are as follows:

Years ending July 31,	
1984	$11,960
1985	12,397
1986	10,759
1987	2,776
	$37,892

Note 5—Stockholders' Equity

In January 1983, the Company sold 660,000 shares of its Common Stock and 330,000 Common Stock Purchase Warrants in a public offering. Each Common Stock Purchase Warrant is not detachable from its Common Stock or exercisable until six months after issuance. Each Warrant entitles the holder to purchase one share of Common Stock at an exercise price of $3.00 after six months and prior to nine months after issuance. The exercise price will increase to $3.50 after nine months and prior to twelve months after issuance. The Warrants will expire twelve months after issuance unless extended by the Company. As of July 31, 1983, 1165 shares were issued pursuant to the exercise of the Warrants.

In connection with the public offering the Company sold 60,000 five-year purchase Warrants to the Underwriters at a price of $.001 per Warrant. Each Warrant entitles the holder to purchase one share of Common Stock at an exercise price of $3.00.

On September 8, 1982, the Company's Board of Directors authorized a three-for-two Common Stock Split effected in the form of a stock dividend distributed to shareholders of records as of that date. All references in the financial statement with regards to number of shares of Common Stock have been restated to reflect the aforementioned Common Stock Split.

On September 1, 1981, 1,143,750 shares of Common Stock were issued or issuable to officers and directors, consideration has been received and is described as follows:

	Value
Equipment	$107,300
Research and development	98,500
Deferred organizational cost	5,000
Reimbursement of expenses	4,200
Deferred registration cost	3,700
	$218,700

Common Stock issued for services was valued at the estimated fair value of services rendered based upon the Board of Directors determination and ratification of the value of services. The value of equipment contributed for Common Stock was based upon the transferors cost. The value of Common Stock for reimbursement of expenses was based upon expenses incurred. All values assigned for expenses and services have been charged to the cost of operations except deferred registration cost and deferred organizational cost.

Sales of Common Stock to private investors are summarized as follows:

Date	Shares	Amount
July 30, 1982	123,214	$115,000
November 1, 1982	28,125	26,250
January 3, 1983	16,071	15,000
Total	167,410	$156,250

On September 8, 1982, 15,000 shares were issued to an unrelated party for laboratory equipment valued at $14,000.

The cash in bank trustee of $80,622 at July 31, 1982 represents the balance of the proceeds of the private offering retained by the Company's attorney for payment of various corporate expenses including lease payments, payroll and registration expenses. Counsel for the Company retained the proceeds from the sale of the stock and distributed said proceeds either to the Company or paid expenses of the Company directly. All amounts paid were for ordinary expenses of the Company and were not paid to any affiliated person, except officer salaries and officers' out-of-pocket expenses.

Note 6—Income Taxes

Certain items of expense, principally depreciation and compensation expenses paid for by the issuance of restricted stock, are recognized in different periods for income tax purposes than for financial reporting purposes. Deferred taxes have not been provided for since the Company has not realized any taxable income since its inception.

As of July 31, 1983, the Company had the following approximate carryforwards available to reduce federal taxable income and taxes:

Expires	Net operating losses	Investment credits	Research and development credits
July 31, 1997	$ 35,000	$ 11,400	$ 500
July 31, 1998	481,100	18,300	14,400
Totals	$516,100	$ 29,700	$ 14,900

Note 7—Commitments and Contingencies

a. Stock Option Plan

The Company has adopted a non-qualified stock option plan and has reserved 300,000 shares for issuance to key employees. Options are non-transferable and expire if not exercised within five years. The options may not be exercisable by the employee until after the completion of one year of employment with the Company. The maximum amount exercisable in any one year is one-fifth of the options granted. The options are issuable to employees in such amounts as determined by the Board of Directors and at such prices as determined by the Board of Directors, except that no single employee will be granted options to purchase more than 15,000 shares. No options have been granted pursuant to the plan.

b. Stock Grant Programs

The Company has adopted a stock grant program effective September 1, 1981, and pursuant to said plan has reserved 375,000 shares of its common stock for issuance originally to key employees. The program requires an employee to remain in the employ of the Company for at least two years following any grant, to agree to assign all know-how patents and proprietory information developed while in the employ of the Company and agree not to engage in any activity which would be considered in competition with the Company's proposed business. If the employee violates any one of these conditions, the ownership of the stock issued under the programs shall revert back to the Company. The Company accounts for the differences, if any, between the fair market value of the stock and the amount the grantee is required to pay at grant date as expense.

On June 22, 1983, the Company issued 20,000 shares of common stock to a Director (see Note 9) in consideration for a sum of $20 and in consideration for consulting and other services. Such shares had a total fair market value of $110,000 on June 22, 1983.

c. Option to Purchase

The Company has obtained for $10 an option to purchase Somerset Breeding Labs, Inc. (a New Jersey Corporation). All of the common stock of Somerset is owned by Andrew Oras, an officer and director of the Company. Mr. Oras, pursuant to the option agreement, has agreed to sell his common stock in Somerset to the Company for $50,000. On November 1, 1982, the Board of Directors determined to cancel the aforementioned option, which cancellation was agreed to by Mr. Oras.

d. Employment Agreements

On September 8, 1982, the Company entered into five-year employment agreements with its principal operating officers for salaries aggregating $145,000 per year subject to annual review.

Note 8—Leases

The Company leases space under an operating lease expiring October 31, 1983 with options to renew for two additional one-year terms. Minimum annual rentals under the initial and optional renewal terms are $60,000, $66,000 and $72,000, respectively. In addition to the basic rent, the Company will pay its prorata share of any real estate tax and utility increase over the base year 1982. The Company also leases certain laboratory equipment under capital lease arrangements for periods of one and five years.

Capital leases

Equipment includes the following amounts for leases which have been capitalized:

Laboratory equipment	$109,971
Less accumulated amortization	10,636
	$ 99,335

At July 31, 1983, future minimum lease payments under capital leases are as follows:

Years ending July 31,	Total
1984	$ 46,576
1985	40,320
1986	40,320
1987	40,320
1988	22,342
Total minimum lease payments	189,878
Less amounts representing executory costs	28,298
Less amounts representing interest (a)	58,365
Present value of net minimum lease payments	103,215
Current portion	18,375
	$ 84,840

(a) Interest rates used to determine present values ranged from approximately 21% to 27%.

Note 9—Subsequent events

On August 12, 1983, the terms of the stock grant program described in note 7(b) were retroactively amended to provide for the issuance of stock to consultants, directors and other persons providing services deemed important to the Company.

On August 12, 1983, the Board of Directors authorized the issuance of 51,000 shares of the Company's common stock to consultants contingent upon the approval of written consulting contracts. Such shares are to be issued under the Company's stock grant program.

During the period August 1, 1983 to September 19, 1983, 3,950 warrants to purchase the Company's common stock at $3.00 per share were exercised.

On September 1, 1983, the Board of Directors granted Andrew Oras, an officer and Director of the Company, the right to terminate his contract of employment with the Company. In consideration, the Company is to receive 80,000 shares of the common stock of Pragma Bio-Tech, Inc., a company in which Mr. Oras owns a controlling interest, and the right of first refusal to exclusively market a certain product of Pragma Bio-Tech, Inc.

Report of Independent Accountants

The Board of Directors and Stockholders
Alfacell Corporation

We have examined the balance sheet of Alfacell Corporation (a Development Stage Company) as of July 31, 1983 and 1982 and the related statements of operations, stockholders' equity and changes in financial position for the year ended July 31, 1983 and for the period from Inception August 24, 1981 to July 31, 1982. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our report dated September 28, 1982, our opinion on the July 31, 1982 financial statements was qualified as being subject to the Company's ability to continue as a going concern which was dependent upon a successful public stock offering and the Company attaining profitable operations. As explained in Note 5, the Company has successfully completed its public stock offering, however, it has not attained profitable operations. Consequently, the continuation of the Company as a going concern is still uncertain.

In our opinion, subject to the effects of the adjustments, if any, that might have been required had the ultimate outcome of the uncertainty about the Company's ability to continue as a going concern been known, the financial statements referred to above present fairly the financial position of Alfacell Corporation as of July 31, 1983 and 1982 and the results of its operations and the changes in its financial position for the year ended July 31, 1983 and from August 24, 1981 to July 31, 1982 in conformity with generally accepted accounting principles applied on a consistent basis.

August 19, 1983 except
as to Note 9 which is
September 19, 1983

CRIPPLE CREEK AND VICTOR GOLD MINING COMPANY
A JOINT VENTURE OF THE GOLDEN CYCLE CORPORATION
Balance Sheets

(A Development Stage Joint Venture)

December 31, 1981 and 1980

	1981	1980
Assets		
Current assets:		
Cash	$ 138	82
Accounts receivable	24	
Supplies inventory	144	
Concentrate inventory	15	
Miscellaneous	2	1
Total current assets	325	84
Mining property, plant and equipment	7,230	2,057
Less accumulated depreciation	781	564
Net mining property, plant and equipment	6,449	1,492
Exploration and development costs	13,748	10,090
	$20,523	11,667
Liabilities and Venturers' Investments		
Current liabilities:		
Accounts payable	$ 341	101
Accrued liabilities	119	54
Advance from Texasgulf, Inc.	110	
Total current liabilities	570	155
Advances from Venturers—call accounts:		
Texasgulf, Inc.	8,478	1,385
Golden Cycle Gold Corporation	1,473	125
Total advances from Venturers	9,952	1,511
Venturers' investments:		
Texasgulf, Inc.	5,000	5,000
Golden Cycle Gold Corporation	5,000	5,000
Total Venturers' investment	10,000	10,000

See Accompanying Notes to Balance Sheets

Notes to Balance Sheets

(A Development Stage Joint Venture)

December 31, 1981 and 1980

(1) Summary of Significant Accounting Policies

(a) General and Basis of Financial Statement Presentation

Cripple Creek and Victor Gold Mining Company was organized in accordance with an agreement dated January 30, 1976, subsequently restated on August 28, 1980, for the purpose of conducting exploration, development, and improvement of certain properties in the Cripple Creek Mining District, Teller County, Colorado. The Venturers in the joint venture are Texasgulf, Inc. (Tg) and Golden Cycle Gold Corporation (GCG). At December 31, 1981, the Joint Venture was conducting exploration and improvement activities and had not commenced commercial production (see note 2). Tg is the manager of the Joint Venture. All costs incurred by the joint venture to December 31, 1981 are considered directly related to exploration and improvement activities and have therefore been capitalized.

Managerial responsibility for the Joint Venture rested with Tg from inception to May 1979 when GCG replaced Tg. Tg reassumed responsibility under the restated agreement in August 1980. As a condition to the restated agreement Tg reimbursed GCG for its expenditures incurred while GCG was manager of the Joint Venture. Such costs were capitalized in the accompanying balance sheet.

(b) Mining Properties and Exploration and Development Costs

Mining properties and exploration and development costs incurred subsequent to organization of the Joint Venture are capitalized and carried at cost and those assets contributed by GCG are recorded at GCG's carrying value. At the present time, the Joint Venture does not have properties or claims proven to be capable of commercial production. The ultimate value of the mining properties and exploration and development costs is dependent upon the development and production of ore reserves in commercial quantities.

(c) Plant and Equipment

Plant and equipment, contributed by GCG is recorded at GCG's stated value. Assets acquired subsequent to organization of the Joint Venture are stated at cost. Depreciation is computed on a straight-line basis over the estimated useful lives of 5 to 25 years. Depreciation is presently being capitalized as a deferred exploration and development cost.

(d) Income Taxes

Income taxes will not be recorded by the Joint Venture because any income or loss will be reported on the respective tax returns of the Venturers.

(e) Capitalization of Interest

During 1980, the joint venture adopted the provisions of FASB Statement No. 34 "Capitalization of Interest Costs." Interest capitalized at December 31, 1980 amounting to $126,207 was included in Exploration and Development Costs. On February 24, 1982, an agreement was reached by the Joint Venturers which clarified the handling of accrued interest on the venturers call accounts. The intent of the Joint Venturers is to have interest accumulating on the call account balances for memorandum purposes only to be used for determining distributions as described in note 2. Accordingly, Exploration and Development Costs have been reduced by $126,207 with Tg's and GCG's call accounts being reduced $80,410 and $45,797, respectively, at December 31, 1980.

(f) Inventories

Supplies inventory is stated at cost using a first-in-first-out basis. Concentrate inventory is stated at the lower of cost or net realizable value.

(2) Organization of Joint Venture

The restated joint venture agreement contains a series of performance obligations, options, and termination provisions at various stages of performance by the Venturers. Tg has proposed a production plan as required by the agreement. Tg is required to invest an additional minimum of $5,000,000 during the "Further Development and Exploration Period." Such amounts will be credited 84% to Tg's and 16% to GCG's "Call Accounts." Such "Call Accounts" are defined as being those funds advanced by the Venturers in excess of the $5,000,000 recorded as each Venturer's contribution as of August 28, 1980. The "Further Development and Exploration Period" shall end the earlier of the date 30 days after production reaches a specified level or August 28, 1983. Upon completion of Tg's investment obligation, additional investments will be provided by Tg and GCG at the rate of 84% and 16%, respectively.

The agreement provides that the respective shares of the Joint Venture and joint venture assets shall be Tg 64% and GCG 36%. The first $10,000,000 of net profits or proceeds shall be distributed to Tg and GCG at the rate of 75% and 25%, respectively. Additional profits or proceeds shall be distributed proportionately to each Venturer based on their "Call Account" balance including interest thereon. Any additional profits or proceeds shall be distributed proportionately based on the shares held by each Venturer.

(3) Exploration and Development Costs

Exploration and development costs incurred from organization of the Joint Venture to December 31, 1981 are as follows:

Prior to organization of Joint Venture—contributed by GCG	$ 4,064,391
Additions	9,454,470
Balance at December 31, 1981	$13,518,861

(4) Mining Property, Plant and Equipment

Mining property, plant and equipment owned by the Joint Venture at December 31, 1981 is as follows:

Mining properties	$ 146,102
Plant and equipment	7,084,304
	$7,230,406

(5) Venturers' Advances—Call Accounts

The Venturers' advances at December 31, 1980 and 1981 are as follows:

	Tg	GCG
Balance at January 1, 1980	$ 168,387	182,194
Contributions by GCG		215,552
Adjustments related to restatement of agreement on August 28, 1980	489,107	(399,814)
Tg payments on behalf of GCG	58,279	
Tg contributions	670,217	127,660
Balance at December 31, 1980	1,385,990	125,592
Adjustments:		
Tg contribution included as short-term advance	(92,400)	(17,600)
Other adjustments	21,658	3,292
Tg payment on behalf of GCG	8,344	
Tg contributions	7,155,047	1,362,123
GCG contribution		548
Balance at December 31, 1981	$8,478,639	1,473,955

(6) Commitments

The Joint Venture's mining properties include unpatented mining claims which require annual assessment work to maintain possessory titles. In addition, the Joint Venture leases various other mining claims.

(7) Related Party Transactions

In the normal course of business, Tg charges the Joint Venture for the direct costs and expenses of employees of Tg performing work directly for the benefit of the Joint Venture. Such charges are reflected primarily in exploration and development costs.

Auditor's Opinion

The Venturers, Cripple Creek and Victor Gold Mining Company:

We have examined the balance sheets of Cripple Creek and Victor Gold Mining Company (a development stage joint venture) as of December 31, 1981 and 1980. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

All costs incurred since the organization of the Joint Venture, as well as those costs contributed at that time, have been capitalized. Therefore, the investment in mining properties, exploration and development costs, and plant and equipment represents substantially all of the Joint Venture assets at December 31, 1981 and 1980. The ultimate value of the aggregate investment in the Joint Venture is dependent upon the discovery, development and processing of ore reserves in commercial quantities.

In our opinion, subject to the effect of such adjustments, if any, as might have been required had the ultimate resolution of the matter discussed in the preceding paragraph been known, the aforementioned balance sheets present fairly the financial position of Cripple Creek and Victor Gold Mining Company at December 31, 1981 and 1980, in conformity with generally accepted accounting principles applied on a consistent basis.

January 25, 1982, except as to note 1(e), which is as of February 24, 1982.

MAGMA ENERGY, INC.
Balance Sheet

	December 31, 1982	December 31, 1981
Assets:		
Current:		
Cash		$ 30
Receivables	1	7
Prepaid expenses	3	6
Total current assets	5	44
Investments in joint ventures in the development stage (Notes 3)	203	375
Land, at cost (Note 6)	814	814
Intangible exploration and development costs, at cost, net of accumulated amortization of $23,575 in 1982 and $15,492 in 1981 (Note 4)	1,495	1,446
Magmamax Power Process patents, at cost, net of accumulated amortization of $34,976 in 1982 and $30,395 in 1981 (Note 4)	101	105
Due from affiliate	9	—
Other assets	11	13
	$2,641	$2,798
Liabilities:		
Current:		
Loan from director (Note 5)	$ 5	—
Accounts payable and accrued liabilities (Note 12)	61	$ 73
Current maturities of long-term debt (Note 6)	1	1
Total current liabilities	68	74
Long-term debt, less current maturities (Note 6)	3	5
Amount payable to parent, Magma Power Co. (Note 2)	213	98
Amount payable to affiliate	15	14
Other noncurrent liabilities	115	122
	416	314
Shareholders' Equity:		
Preferred stock—noncumulative, convertible, $1.00 par value; authorized 4,000,000 shares (1982 and 1981); issued and outstanding 731,120 shares (1982 and 1981), aggregate liquidation preference $2,924,480 (Note 7)	731	731
Common stock—$.02 par value, authorized 20,000,000 shares (1982 and 1981); issued and outstanding 7,761,404 in 1982 and 7,749,000 in 1981) (Note 8)	155	154
Additional paid-in capital (Note 8)	5,668	5,618
Deficit accumulated during the development stage (Note 13)	(4,329)	(3,995)
	2,225	2,509
Less, Note receivable from employee (Note 8)	—	(25)
Total shareholders' equity	2,225	2,483
	$2,641	$2,798

The accompanying notes are an integral part of this statement.

Statement of Operations

	Year Ended December 31, 1982	1981	1980
Revenues:			
Gain on disposition of investment in Geothermal Food Processors	—	$212	—
Rental and other income	$ 64	57	$ 73
	64	270	73
Cost and expenses:			
Depreciation and amortization	18	26	12
General and administrative	165	173	179
Provision for investment in joint venture (Note 3)	201	8	—
Abandoned leases and wells (Note 5)	4	37	—
Interest	8	8	9
	397	254	201
Income (loss) before taxes and extraordinary item	(333)	15	(128)
Income Taxes (Note 9)	—	7	—
Income (loss) before extraordinary item	(333)	8	(128)
Extraordinary item—tax carryforward (Note 9)	—	7	—
Net income (loss)	($333)	$ 15	($128)
Net loss per common share (Note 10)	($.04)	—	($.02)

The accompanying notes are an integral part of the statement.

Statement of Changes in Financial Position

	Year Ended December 31, 1982	1981	1980
Working capital was provided by:			
Proceeds from disposition of investment in Geothermal Food Processors	—	$675	—
Payments of notes by officer and employee	$ 25	—	$ 17
Loans from parent	15	—	61
Issuance of common shares	49	—	—
Total working capital provided	90	675	78
Working capital applied to (provided from):			
Operations:			
Net (income) loss	333	(15)	128
Add (deduct) items not requiring working capital in the current period:			
Gain on disposition of investment in Geothermal Food Processors	—	212	—
Charges from parent	(100)	(108)	(108)
Charges from affiliate	(1)	(14)	—
Charges to affiliate	9	—	—
Depreciation and amortization	(18)	(26)	(12)
Provision for investment in joint venture (Note 3)	(201)	(8)	—
Abandoned leases and wells (Note 5)	(4)	(37)	—
Working capital applied to operations	17	2	7
Intangible exploration and development costs	65	427	7
Loans to parent	—	168	—
Investments in joint ventures in the development stage	29	98	67
Other, net	10	16	13
Total working capital applied	122	714	96
Decrease in working capital	(32)	(39)	(17)

Increase (decrease) in components of working capital:			
Cash	(29)	8	(44)
Receivables	(5)	4	(6)
Prepaid expenses	(3)	1	(3)
Loans from director	(5)	—	—
Accounts payable and accrued liabilities	12	(46)	18
Current maturities of long-term debt	—	(7)	18
Decrease in working capital	($ 32)	($ 39)	($ 17)

The accompanying notes are an integral part of this statement.

Statement of Shareholders' Equity

	Preferred Stock Shares (Note 7)	Preferred Stock Amount	Common Stock Shares (Note 8)	Common Stock Amount	Additional Paid-In Capital (Note 8)	Deficit Accumulated In The Development Stage (Note 13)	Notes Receivable From Officer And Employee (Note 8)	Total Shareholders' Equity
Balance, December 31, 1979	731	$731	7,749	$154	$5,618	($3,882)	($42)	$2,579
Cash payments received on note receivable	—	—	—	—	—	—	17	17
Net loss, 1980	—	—	—	—	—	(128)	—	(128)
Balance, December 31, 1980	731	731	7,749	154	5,618	(4,011)	(25)	2,468
Net income, 1981	—	—	—	—	—	15	—	15
Balance, December 31, 1981	731	731	7,749	154	5,618	(3,995)	(25)	2,483
Net loss, 1982	—	—	—	—	—	(333)	—	(333)
Cash payment received on note receivable	—	—	—	—	—	—	25	25
Issuance of common stock to cancel debt (Note 8)	—	—	12	—	49	—	—	49
Balance, December 31, 1982	731	$731	7,761	$155	$5,668	($4,329)	—	$2,225

The accompanying notes are an integral part of this statement.

Notes to Financial Statements

1. Business:

Since its inception, Magma Energy, Inc. (the Company) has been in the development stage with its primary activity that of exploring and developing geothermal resources. The Company does not as yet have revenues from the sales of geothermal energy. The Company's capital is primarily supplied by its parent, Magma Power Company (Magma Power), which owns approximately 65% of the Company's outstanding common stock and 100% of the preferred stock, and various other entities with which the Company has joint ventures in the development stage.

The Company's ability to recover capitalized costs of investments in the development stage and intangible exploration and development costs depends upon the Company and its joint venturers and other projects in which the Company has interests commencing profitable operations, which presently cannot be determined.

The Company's other significant accounting policies are described in the following notes:

2. Intercompany Charges:

In order to reduce administrative costs Magma Power pays all of the Company's payroll, general and administrative costs. The Company is charged monthly by Magma Power an amount which is determined to be its share of such costs incurred.

3. Investments In Joint Ventures In The Development Stage:

The Company as co-venturer has investments in several projects for the purpose of drilling and developing wells for the production of geothermal energy. The Company's investment, at cost, represents drilling and lease acquisition and carrying costs net of allowance for abandoned leases and wells. At such time as the joint ventures begin operations, the Company will account for joint venture operations by including in its accounts its share of the joint venture accounts.

The Company has a number of joint ventures with Magma Power and its wholly-owned subsidiaries. The allocation of exploration and development costs related to these joint ventures, with the exception of Magma Energy—Imperial Magma joint venture, which have been incurred by Magma Power and its wholly-owned subsidiaries, has not as yet been determined. Accordingly, these costs are not included in the Company's intangible exploration and development costs.

Magma Energy—Imperial Magma Joint Venture:

The Company and Imperial Magma (wholly-owned subsidiary of Magma Power) have developed their East Mesa interests to supply geothermal energy for a 11,000 kw power plant constructed by Magma Electric (wholly-owned subsidiary of Magma Power).

Magma Electric entered into an agreement to sell electricity generated by the plant to San Diego Gas & Electric Company (SDG&E) at a price fixed for the first three years of operations, the price to be negotiated thereafter. SDG&E has entered into an agreement to sell the power to Imperial Irrigation District, the local utility, without markup.

No significant revenues to date have been realized, since the plant commenced operations in February 1980. However, the method of allocating revenues and operating costs has been determined in an agreement entered on April 10, 1981 between Magma Energy, Magma Power and Imperial Magma. Under the terms of the agreement, Imperial Magma and Magma Power will expend whatever monies are required to explore and develop geothermal resources. Magma Energy will not be charged with any interest cost or with any general or administrative expenses. Out of the proceeds, if any, from the sale of geothermal resources, Imperial Magma and Magma Power will first be repaid for all expenditures. Magma Energy shall, thereafter, participate in 50% of the proceeds up to the amount sufficient to supply 65,000 kw gross rated capacity for generation of electricity.

Other Joint Ventures:

The Company's other joint ventures are not as active at this time. The Company continues to retain leaseholds and anticipates development in the future.

During 1982 and 1981, the Company determined certain joint venture leases and wells in the Mountain Home and Niland area of California were not suitable for further use. Accordingly, a provision for investment in joint ventures representing intangible exploration and development costs previously capitalized of approximately $201,000 in 1982 and $9,000 in 1981 were charged to operations.

4. Intangible Exploration And Development Costs And Magmamax Power Process Patents:

Intangible exploration and development costs include expenditures for geothermal processing equipment patents, licenses and rights, and capitalized lease and well costs. Intangible exploration and development costs will be amortized over the life of successful processes and leases or estimated reserves. When a geothermal lease or project is abandoned, all related capitalized costs are charged to operations in the year of abandonment. During 1982 and 1981, the Company determined that certain wells in Hazen, Brady, Nevada and other locations were not suitable for further development. Accordingly, intangible exploration and development costs of approximately $4,000 and $37,000 were charged to operations in 1982 and 1981, respectively.

In May 1981, the Company sold all of its rights, title and interest in a 160-acre lease and geothermal wells thereon in the Brady, Nevada area for $675,000. A gain of approximately $213,000 was recognized from this transaction.

In July 1981, the Company entered into an agreement with New Albion Resources Co. (NARCO) to purchase all of NARCO's rights and interests in certain geothermal leases on land located in Imperial County, California for $400,000.

Patents granted are amortized over a 17-year period using the straight-line method. On March 1, 1982, the Company entered into a letter of intent with certain parties with respect to such parties utilizing the Company's patented Magmamax process to construct and operate a geothermal power plant on land owned by the Company near Mammoth, California. Definitive agreements have not as yet been entered into.

5. Loan From Director:

During 1982, the Company borrowed from Joseph W. Aidlin, secretary, general counsel, and director of Magma Power approximately $5,500. The loan is non-interest bearing and payable on demand.

6. Long-Term Debt:

The long-term debt at December 31, 1982 consists of a 7% note with a deed of trust on land as collateral. Principal payments due subsequent to 1982 are not significant in any one year through maturity.

7. Preferred Stock:

Each preferred share is entitled to one vote on the same basis as each common share and is convertible, at the option of the holder, into one share of common stock. The preferred shares are redeemable, at the Company's option, at $4 per share and have voluntary and involuntary liquidation preference of $4 per share.

8. Common Stock:

During 1982, the Company issued 12,404 shares of restricted common stock to Magma Power Company in exchange for the cancellation of certain debt. (See Note 11.)

At December 31, 1982, there were 215,000 shares remaining and permitted to be granted under nonqualified stock option plan approved by the stockholders in 1970. The option price shall be fixed by the board of directors or, if not so fixed, shall be not less than $1.25 per share. Options are exercisable at date of grant and may not be exercised later than seven years from the date of grant. A promissory note totalling $25,500, which was received in consideration for options exercised, was deducted from stockholders' equity in 1981 and was paid in 1982. There were no options outstanding at December 31, 1982 and 1981 and no options were exercised during 1982, 1981 and 1980.

When options are exercised, the par value of shares purchased is credited to common stock and the excess credited to additional paid-in capital. The Company makes no charges to income in connection with the options referred to above.

9. Income Taxes:

The extraordinary credit in 1981 results from the carry-forward of Federal income tax operating losses.

At December 31, 1982, the Company had tax loss carry-forwards for Federal income tax purposes of approximately $2,177,000 available to reduce the tax on future year's taxable income, if any, expiring as follows: $520,000—1991; $303,000—1992; $107,000—1993; $333,000—1994; $250,000—1995; $449,000—1996; $215,000—1997.

10. Net Income (Loss) Per Common Share:

Net income (loss) per common share was computed using the weighted average number of common shares outstanding of 7,752,875 in 1982 and 7,749,000 in 1981 and 1980. No preferred stock conversion rights have been considered in the calculation of net loss per share for 1982 and 1980 as the impact would be antidilutive. Primary and fully diluted earnings per share for 1981 are the same.

11. Employee Benefit Plans:

The Company, Magma Power and its wholly-owned subsidiaries have a profit-sharing employee stock ownership plan (Plan) covering substantially all employees. The Plan is noncontributory and employer contributions are funded as accrued by contributing common stock of Magma Energy. Contributions under the Plan are based upon a defined percentage of participant's salaries. Under the Plan, the participant's interest is subject to specified vesting provisions. The liability of the Company is limited to the funds in the profit-sharing trust. The total cost of the Plan was approximately $13,000 in 1981, and $163,000 in 1980. There were no costs associated with this Plan in 1982. The Company's share of these costs in 1981 and 1980 are included in the monthly administrative charge from Magma Power.

Effective January 1, 1982 the Company, Magma Power and its wholly-owned subsidiaries, terminated its target benefit employee stock ownership plan which covered substantially all employees. Contributions under this plan were based upon an amount required to provide an annuity at retirement of 13% of the participant's highest average monthly compensation over a period of three consecutive years. During 1982, 12,404 shares of restricted common stock of Magma Energy were issued and transferred to the Trustee of the Plan in satisfaction of Magma Power's obligation to make the 1981 contribution. The Company has no remaining liability with respect to this plan at December 31, 1982 and all amounts remaining in the target benefit trust will be distributed to the participants. The total costs of this plan for the years ended December 31, 1981 and 1980 was $50,000 and $23,000, respectively. There were no costs associated with this plan in 1982.

The Company and Magma Power have unfunded deferred compensation arrangements with three key employees. The arrangements generally provide that the employee shall receive for life upon retirement a specified monthly amount less normal social security benefits and any other retirement benefits payable under the plans described above. Estimated future benefits under these arrangements are being accrued over a twenty-year period. Amounts accrued for 1982, 1981 and 1980 were $29,000, $39,000 and $9,000, respectively. The Company's share of these costs for 1982, 1981 and 1980 are included in the monthly administrative charge from Magma Power.

12. Accounts Payable And Accrued Liabilities:

Accounts payable and accrued liabilities consist of:

	1982	1981
Accounts payable, trade	$ 722	$22,946
Payable to former joint venture partner	25,000	25,000
Current portion of other noncurrent liabilities	16,634	14,000
Accrued interest	18,462	10,943
Other	819	819
	$61,637	$73,708

13. Development Stage Financial Data:

The following information summarizes the Company's financial activities since inception:

(a) Summary Of Cumulative Loss From Inception (March 30, 1959) To December 31, 1982:

Revenues:	
Rental and other income	$ 840,520
Gain on disposition of investment in Geothermal Food Processors	212,633
	1,053,153
Cost and expenses:	
Depreciation and amortization	485,597
General and administrative	2,224,495
Research and development	311,016
Provision for investment in joint venture	210,214
Abandoned leases and wells	1,198,100
Interest	599,845
	5,029,267
Loss before equity in net loss of discontinued operations, income taxes, and extraordinary items	(3,976,114)
Equity in net loss of discontinued operations	(219,335)
Loss before income taxes and extraordinary items	(4,195,449)
Income taxes	(7,183)
Extraordinary items:	
Abandonment in 1972 of rights to New Mexico uranium leases acquired in 1969	(133,598)
Utilization of tax loss carry-forwards in 1981	7,183
Cumulative loss at December 31, 1982	($4,329,047)

(b) Summary Of Changes In Financial Position From Inception (March 30, 1959) To December 31, 1982:

Working Capital was provided by:	
Issuance of common shares for cash	$2,597,471
Issuance of common shares to fund retirement plan	49,619
Long-term debt	639,000
Loans from parent	3,957,189
Proceeds from disposition of investment in Geothermal Food Processors	675,000
Total working capital provided	7,918,279

Working capital was applied to:	
Operations:	
Loss before equity and net loss of discontinued operations	3,976,114
Add (deduct) items not requiring working capital:	
Gain on disposition of investment in Geothermal Food Processors	212,633
Charges from Magma Power and affiliate	(624,528)
Deferred compensation provision	(58,000)
Depreciation and amortization	(485,597)
Provision for investment in joint venture	(210,214)
Abandoned leases and wells	(1,198,100)
Working capital applied to operations	1,612,308
Transfer to Geothermal Food Processors, Inc.	462,367
Transfer from intangible costs	(462,367)
Reduction of loans from Magma Power ($2,924,480 converted into preferred stock)	4,127,533
Issuance of preferred stock and sale of geothermal equipment to Magma Power	(3,905,313)
Investments in joint ventures in the development stage	900,791
Intangible exploration and development costs	2,776,107
Land	815,045
Equipment for use in geothermal operations	572,871
Investments in and loans to subsidiary	219,335
Loans to parent	168,846
Reduction of long-term debt	631,598
Other, net	62,158
Total working capital applied	7,981,279
Decrease in working capital	($ 63,000)

Auditors' Report

The Board of Directors
Magma Energy, Inc.

We have examined the balance sheet of Magma Energy, Inc. as of December 31, 1982 and 1981, and the related statements of operations, shareholders' equity, and changes in financial position for the years ended December 31, 1982, 1981 and 1980. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Since its inception, the Company has been in the development stage with its primary activity that of exploring for and developing geothermal resources. However, the Company does not as yet have revenues from the sale of geothermal energy. The Company's capital is supplied directly by its parent, Magma Power Company (Magma Power) whose capital is supplied directly by B. C. McCabe, chairman and principal shareholder of Magma Power. Mr. McCabe has advised the directors of Magma Power that he will continue to provide capital to Magma Power during 1983.

As discussed in Note 1 to the financial statements, the ultimate recovery of capitalized costs of investments in the development stage and intangible exploration and development costs is dependent upon future profitable operations which presently cannot be determined and upon continued financial support from Magma Power.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the preceding two paragraphs been known, the financial statements referred to above present fairly the financial position of Magma Energy, Inc. at December 31, 1982 and 1981 and the results of its operations and changes in financial position for the years ended December 31, 1982, 1981 and 1980, in conformity with generally accepted accounting principles applied on a consistent basis.

March 22, 1983

(c) Condensed Summary Of Stockholders' Equity From Inception (March 30, 1959) To December 31, 1982:

			Preferred Stock		Common Stock			
Year	Description	Amount Per Share	Number Of Shares	Amount	Number Of Shares	Amount	Additional Paid-In Capital	Total Amount
1959	Initial issuance for cash	$ .10	—	—	250,000	$ 25,000	—	$ 25,000
1961-1966	Amortization of organization costs	—	—	—	—	—	($317)	(317)
1967	Issuance for forgiveness of indebtedness and cash payment of certain lease costs by the parent, Magma Power Company	.86	—	—	217,422	21,742	164,933	186,675
	Issuance in exchange for the transfer of assets (principally land, investments in joint ventures and intangible exploration and development costs) from the parent, Magma Power Company, at book value	.86	—	—	532,578	53,258	404,006	457,264
1969	Issuance in exchange for mining leases and a geothermal resources lease covering a total of approximately 39,500 acres in New Mexico, at fair market value	4.38	—	—	28,300	2,830	121,030	123,860
	Issuance for cash	4.56	—	—	450,000	45,000	2,008,096	2,053,096
1974	Exercise of stock options by certain directors, field and office personnel for promissory notes	6.25	—	—	33,500	3,350	206,025	209,375
	Excess of sale price over book value of geothermal equipment sold	—	—	—	—	—	190,000	190,000
1976	Five-for-one common stock split	—	—	—	6,047,200	—	—	—
1977	Exercise of stock options for cash	1.78	—	—	92,500	1,850	162,650	164,500
	Issuance of preferred stock in cancellation of debt to parent	4.00	731,120	$731,120	—	—	2,193,360	2,924,480
1978	Exercise of stock options for cash	1.96	—	—	42,500	850	82,650	83,500
1979	Exercise of stock options for cash and promissory notes	1.59	—	—	55,000	1,100	86,400	87,500
1982	Issuance of common stock to cancel debt	4.00	—	—	12,404	248	49,371	49,619
	Balance, December 31, 1982		731,120	$731,120	7,761,404	$155,228	$5,668,204	$6,554,552

OPINION WITHOUT "SUBJECT TO" QUALIFICATION

CELLULAR TECHNOLOGY INC.
Consolidated Balance Sheet
(Development Stage Companies)
June 30, 1983

Assets	
Current assets:	
Cash (Note 2)	$2,393,218
Prepaid expenses	5,881
Total current assets	2,399,099
Certificates of authority and communication licenses	48,835
Office equipment, less accumulated depreciation of $148	839
	$2,448,773
Liabilities and Shareholders' Equity	
Current liabilities:	
Accounts payable	$ 29,545
Taxes—payroll, etc.	5,016
Total current liabilities	34,561
Commitments (Note 3)	
Shareholder's equity:	
Common stock—$0.01 par value	
Authorized—8,000,000 shares	
Issued—6,560,000 shares (Notes 4, 5 and 6)	65,600
Capital in excess of par value	2,370,187
Deficit accumulated during the development stage (Note 7)	(21,575)
	2,414,212
	$2,448,773

See accompanying notes to consolidated balance sheet.

Notes to Consolidated Balance Sheet
(Development Stage Companies)

Note 1—Summary of Accounting Principles:

The consolidated balance sheet includes the accounts of the Company and its wholly owned subsidiaries, High Tech Industries, Inc. and High Tech Communications Corp. The Company and its subsidiaries are Delaware corporations incorporated on December 23, 1982, November 3, 1982 and July 19, 1982 respectively. All intercompany transactions were eliminated.

The Company and its subsidiaries are in the initial stages of development and have had no operating history. They are applying for licenses to operate cellular mobile radio telephone systems and radio paging systems in various cities in the United States. The engineering and legal fees incurred to June 30, 1983 comprise the "Certificates of authority, and communication licenses" caption in the balance sheet.

The companies defer expensing all legal and engineering costs directly related to the applications for certificate of authority until the Company knows with certainty the outcome of such applications. If any such application is denied, the attributable costs will be expensed and, if approved, the attributable costs will be amortized over a forty-year period. If it becomes apparent that the value of a particular certificate of authority is diminishing over a period shorter than forty years, amortization will be adjusted appropriately to recognize such circumstances.

Note 2—Source and Application of Funds From the Company's Inception:

Source of funds:		
From subscribers to capital stock:		
January 1983	$ 2,000	
February 1983	10,000	
March 1983	354,428	
From underwriter upon public issue—June 1983	2,500,000	
Unpaid expenses and taxes	34,561	$2,900,989
Use of funds:		
Expenses in connection with stock offering	430,641	
Engineering and legal fees	48,835	
Office equipment	987	
Prepaid expenses	5,881	
Loss during development stage, less depreciation of $148	21,427	507,771
Cash balance, June 30, 1983		$2,393,218

Note 3—Commitments:

During August 1983, the Company entered into three-year employment contracts with two key employees for aggregate annual salaries ranging from $93,000 to $112,000. In addition, these employees were granted stock options as described in Note 6.

Note 4—Capital Stock:

The aggregate cash consideration for the outstanding capital stock at balance sheet date consists of:

Number of shares	Price per share	Amount
3,910,000	$.0933	$ 364,928
150,000	.0100	1,500
2,500,000	1.0000	2,500,000
6,560,000		2,866,428
Less expenses in connection with stock offering		(430,641)
		$2,435,787

Note 5—Purchase Warrants to Be Sold:

In connection with the offering to the public of 2,500,000 shares of common stock, par value $0.01, at $1.00 per share, the Company agreed to sell 225,000 common stock purchase warrants to the underwriter for an aggregate of $22.50. Each warrant may be converted into one share of common stock, par value $0.01, at the exercise price of $1.40 per share for a period of four years commencing with the thirteenth month after the date of issue of such warrant. The underwriter purchased such warrants in August 1983.

Note 6—Key Employee Stock Options:

Pursuant to a non-qualified stock option plan, the Company may grant options to key employees on 300,000 shares of the Company's common stock at an exercise price of at least $0.125 per share. During August 1983, in connection with three-year employment contracts with two key employees, options on an aggregate of 75,000 shares were granted at an exercise price of $0.125, exercisable as follows: fiscal 1984—45,000; fiscal 1985—10,000; fiscal 1986—10,000; contingent upon company earnings—10,000.

Note 7—Deficit Accumulated During the Development Stage:

During the period from January 14, 1983 (Inception) to June 30, 1983, the consolidated group incurred administrative costs of $40,337 (including depreciation of $187) and earned interest income of $18,762, resulting in a deficit of $21,575.

Opinion of Independent Certified Public Accountants

Board of Directors and Stockholders
of Cellular Technology Inc.

We have examined the consolidated balance sheet of Cellular Technology Inc. and subsidiaries (development stage companies) at June 30, 1983. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated balance sheet presents fairly the financial position of Cellular Technology Inc. and subsidiaries at June 30, 1983, in conformity with generally accepted accounting principles.

September 21, 1983

GEOKINETICS INC.
Statements of Financial Position
(A Development Stage Company)

September 30, 1980 and 1981	1980	1981
Assets		
Current Assets:		
Cash	$ 32,546	$ 98,269
Short term investments, at cost which approximates market	2,890,900	3,149,866
Receivables	21,136	318,130
Inventories (Note 1)	139,509	59,876
Prepaid expenses	51,197	51,198
Total	3,135,288	3,677,339
Property and Equipment (Notes 1, 2 and 3):		
Oil shale leases	530,903	530,903
Office furniture and equipment	16,894	19,700
Total	547,797	550,603
Less accumulated depreciation	10,086	11,719
Net	537,711	538,884
Total	$3,672,999	$4,216,223
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	$ 136,175	$ 193,320
Income taxes payable		175,234
Accrued compensation and other expenses	107,100	169,036
Unexpended reimbursements (Note 1)	50,861	48,482
Total	294,136	586,072
Commitments and Contingencies (Note 3)		
Stockholders' Equity (Note 6):		
Common stock $.20 par value (5,000,000 shares authorized; 2,794,000 shares issued and outstanding at September 30, 1980 and 1981)	558,800	558,800
Additional capital	3,363,774	3,363,774
Deficit accumulated during the development stage	(543,711)	(292,423)
Net	3,378,863	3,630,151
Total	$3,672,999	$4,216,223

See Notes to Financial Statements

Statements of Operations

(A Development Stage Company)

For the Years Ended September 30, 1979, 1980 and 1981 and for the Period from March 7, 1969 (Inception) to September 30, 1981	1979	1980	1981	From Inception (Unaudited)
Costs and Expenses:				
Engineering, research and development (Notes 1 and 2):				
Noncapital expenditures	$1,338,614	$1,490,252	$2,514,328	$7,703,773
Capital expenditures	309,550	218,717	786,391	1,803,400
Administrative and general	302,241	459,245	763,623	2,285,895
Oil shale lease rentals	27,520	57,274	61,118	145,912
Amortization, depreciation, and other	14,470	7,125	1,882	318,952
Total	1,992,395	2,232,613	4,127,342	12,257,932
Less:				
Cost reimbursements (Note 2):				
U.S. Department of Energy	1,713,140	2,050,936	3,794,427	9,590,473
Joint venture partner	146,568			1,431,038
Shale oil sales	43,123	28,437	266,002	360,878
Interest income	13,096	117,424	495,393	653,548
Management fees	13,950			144,660
Other—net	8,611	15,381		(27,239)
Total	1,938,488	2,212,178	4,555,822	12,153,358
Income (loss) before income taxes and extraordinary credit	(53,907)	(20,435)	428,480	(104,574)
Income taxes (Note 4)	225	9,161	177,192	235,249
Income (loss) before extraordinary credit	(54,132)	(29,596)	251,288	(339,823)
Extraordinary credit—realization of tax loss carryfowards (Note 4)		5,861		47,400
Net Income (Loss)	$ (54,132)	$ (23,735)	$ 251,288	$ (292,423)
Earnings (loss) per common share (Note 1):				
Income (loss) before extraordinary credit	$ (.02)	$ (.01)	$ .09	
Extraordinary credit		nil		
Net Income (Loss)	$ (.02)	$ (.01)	$ .09	
Weighted average common shares and equivalents outstanding (Note 1)	2,344,000	2,540,875	2,794,000	

See Notes to Financial Statements

Statements of Changes in Financial Position

(A Development Stage Company)

For the Years Ended September 30, 1979, 1980, and 1981 and for the Period from March 7, 1969 (Inception) to September 30, 1981	1979	1980	1981	From Inception (Unaudited)
Sources of Funds:				
Operations:				
Net income (loss)	$ (54,132)	$ (23,735)	$251,288	$ (292,423)
Items not requiring the use of working capital:				
Depreciation	1,967	1,477	1,633	12,396
Amortization of technical plans and other intangibles	12,500			300,000
Total	(39,665)	(22,258)	252,921	19,973
Issuance of common stock:				
For cash		2,862,947		3,138,947
For technical plans and other intangibles				300,000
Assets contributed by joint venture partner	483,627			483,627
Total	443,962	2,840,689	252,921	3,942,547
Uses of Funds:				
Property and equipment:				
Oil shale leases	522,553	8,350		530,903
Office furniture and equipment	1,181	1,732	2,806	20,377
Technical plans and other intangibles				300,000
Total	523,734	10,082	2,806	851,280
Increase (Decrease) in Working Capital	$ (79,772)	$2,830,607	$250,115	$3,091,267

Changes in Working Capital by Element

	1979	1980	1981	From Inception (Unaudited)
Increase (Decrease) in current assets:				
Cash and short term investments	$(271,540)	$2,826,713	$324,690	$3,248,136
Receivables	(218,234)	216	296,993	318,129
Inventories	166,258	(26,749)	(79,632)	59,877
Prepaid expenses	47,809	3,388		51,197
Decreases (Increases) in current liabilities:				
Note payable to stockholder	(10,000)	10,000		
Accounts payable	(103,946)	12,630	(57,145)	(193,320)
Advances from joint venture partners	456,007			
Income taxes payable			(175,234)	(175,234)
Accrued compensation and other expenses	(31,554)	(15,346)	(61,936)	(169,036)
Unexpended reimbursements	(114,572)	19,755	2,379	(48,482)
Increase (Decrease) in Working Capital	(79,772)	$2,830,607	$250,115	$3,091,267

See Notes to Financial Statements.

Statement of Stockholders' Equity
(A Development Stage Company)

For the Period from March 7, 1969 (Inception) to September 30, 1981
(Amounts for the period from inception to September 30, 1976 are unaudited)

Date	Transaction	Common Shares Issued	Per Share	Consideration	Common Stock	Stockholders' Equity Additional Capital	Accumulated Deficit	Net Equity
	Common stock issued for							
June 1969	Cash	520,000	$ .25	$130,000	$130,000			$ 130,000
June 1969	Technical plans and other intangibles (Note 6)	1,200,000	.25	300,000	300,000			300,000
July 1969	Cash	80,000	.25	20,000	20,000			20,000
August 1972	Cash	120,000	.25	30,000	30,000			30,000
November 1972	Cash	260,000	.25	65,000	65,000			65,000
August 1973	Cash	84,000	.25	21,000	21,000			21,000
November 1974	Cash	80,000	.125	10,000	10,000			10,000
Inception to Sept. 30, 1977	Net loss						$(517,613)	(517,613)
Balance at September 30, 1977		2,344,000		576,000	576,000		(517,613)	58,387
Year Ended Sept. 30, 1978	Net income						51,769	51,769
Balance at September 30, 1978		2,344,000		576,000	576,000		(465,844)	110,156
February 1979	Assets contributed by joint venture partner (Note 6)					$ 483,627		483,627
Year Ended Sept. 30, 1979	Net loss						(54,132)	(54,132)
Balance at September 30, 1979		2,344,000		576,000	576,000	483,627	(519,976)	539,651
	Change from no-par to $.20 par value				(107,200)	107,200		
April 1980	Net proceeds from public offering of common stock	450,000	7.50	2,862,717	90,000	2,772,717		2,862,717
	Sale of stock purchase warrant for 23,000 shares (Note 6)			230		230		230
Year Ended Sept. 30, 1980	Net loss						(23,735)	(23,735)
Balance at September 30, 1980		2,794,000		3,438,947	558,800	3,363,774	(543,711)	3,378,863
Year Ended Sept. 30, 1981	Net income						251,288	251,288
Balance at September 30, 1981		2,794,000		$3,438,947	$558,800	$3,363,774	$(292,423)	$3,630,151

See Notes to Financial Statements.

Notes to Financial Statements
(A Development Stage Company)

(Amounts for the cumulative period from March 7, 1969 (inception) to September 30, 1981 are unaudited)

1. Accounting Policies

The Company is engaged in acquisition of oil shale lands and in research and development of processes to extract oil from oil shale. As more fully explained in Note 2, such research and development has been funded primarily by the U.S. Department of Energy (DOE). Significant accounting policies are set forth below.

Inventories

Inventories at September 30 consist of the following:

	1980	1981
Materials and supplies	$ 47,149	$59,876
Shale oil	92,360	0
Total	$139,509	$59,876

Shale oil is being recovered from research and development activities. During this development stage, such oil is considered a by-product of such activities and is stated at net realizable value (which does not exceed cost). Materials and supplies are stated at first-in, first-out cost (not in excess of market).

Prior to 1979, inventories were not significant and shale oil extraction costs and purchases of materials and supplies were charged to operations as incurred. Prior to late 1980, revenues realized from shale oil sales reduced DOE reimbursements. Effective December 1980, the DOE agreement was amended to provide that all shale oil produced thereafter would be solely owned by the Company.

Oil Shale Leases

Lease acquisition costs are capitalized and will be amortized when commercial production begins on a units-of-production method based on recoverable shale oil in place as estimated by the Company's independent consulting geologist.

Engineering, Research, and Developmental Costs

Engineering, research, and developmental costs, other than inventories, are charged to operations. The majority of such costs have been reimbursed by DOE under cost-reimbursement arrangements more fully explained in Note 2. Related expenditures for equipment have been charged to operations when purchased. During 1981, DOE informed the Company that the DOE would terminate the agreement after the fiscal 1981 appropriation had been expended. Under the agreement at its expiration or termination, the DOE may direct the Company to sell the equipment and share with the Company the net proceeds in accordance with the cost sharing ratio in effect when such items were purchased, unless the Company elects to continue the Project for at least another year without DOE support. The Company plans to continue the work through the next succeeding phase of the project, which phase is expected to be completed late in 1982. See Note 2 for further discussion of the capital equipment that has been charged to operations.

Cost Reimbursements

Cost reimbursements are recognized when the related costs and expenses are charged to operations. Any excess of funds advanced over costs and expenses incurred is reported as unexpended reimbursements.

Income Taxes

Investment, additional research, and new jobs tax credits are recognized as reductions of the Company's income tax provisions using the flow-through method to the extent such credits can be utilized based on the Company's financial statement income.

Earnings (Loss) per Common Share

Earnings (loss) per common share are computed based on the weighted average number of common shares and equivalents outstanding. Stock options and stock purchase warrants are not considered common stock equivalents when the effects would be antidilutive.

2. Developmental Operations

The Company, a developmental stage enterprise, is engaged in acquiring oil shale leases and research and development of processes to extract shale oil from oil shale. Since the Company is in the developmental stage, there are substantial uncertainties with respect to the timing and ultimate cost of future development activities and shale oil extraction. To date, substantially all engineering, research and development costs as well as general and administrative expenses have been reimbursed under various arrangements described below.

Prior to 1979, the Company organized and operated joint venture arrangements with independent oil companies in consideration for management fees and oil shale interests. All but one of the joint venture partners withdrew from the project during 1975 and the remaining partner withdrew early in fiscal 1979.

Since late 1976 the Company has operated under a cost-reimbursement agreement with DOE and the remaining joint venture partner (until its withdrawal from the project in December 1978) under which substantially all project expenditures, as defined, have been reimbursed by DOE and the joint venture partner. Effective January 1979, DOE reimbursed 97% of such expenditures and the Company paid the remaining 3% until May, 1981 when the DOE reimbursement rate was reduced to 90%.

Since the DOE Agreement may be terminated prior to completion of the LOFRECO R & D project, the Company is seeking funding of its research and development activities from other sources in order to continue the project. The availability of such funding could be affected by the prevailing economic and market conditions, and there is no assurance that the necessary funds can be obtained.

The DOE Agreement provides for termination by either party with sixty days prior written notice. If terminated, the other party could elect to continue the project through the next succeeding phase. Upon completion of work under that phase, all project assets, other than machinery and equipment, are then required to be assigned to the non-terminating party. If the non-terminating party is unable to continue, project assets (other than shale oil lease rights, which are owned exclusively by the Company) would be disposed of. Any proceeds, after satisfaction of project liabilities, would be shared based on the cost sharing ratios in effect at the time the respective assets were acquired.

As previously explained, DOE also has rights in the event of early termination of the Agreement to certain machinery and equipment used in the Company's operations. Such machinery and equipment, which has been charged to operations through September 30, 1981, is summarized below. DOE has agreed to let the Company use such machinery and equipment, if the Company supports the project on its own account through the next succeeding phase for at least one year after the remaining DOE funds have been expended. At September 30, 1981, approximately $824,000 of the fiscal 1981 appropriation had not yet been expended.

	Estimated Useful Lives	Cost	Accumulated Depreciation*	Net
Operating machinery and equipment	Various to 20 years	$1,174,040	$281,083	$ 892,957
Automotive equipment	3-5 years	131,831	91,577	40,254
Camp housing and support systems	5-20 years	226,179	87,027	139,152
Laboratory and other experimental and monitoring equipment	3-5 years	266,601	108,520	158,081
Total		$1,798,651	$568,207	$1,230,444

*As if capitalized.

The depreciation amounts shown above are based on the straight line method over estimated useful lives. Based on an unaudited evaluation of the oil shale leases by the Company's independent consulting geologist dated January 1980 and a 40% recovery rate, recoverable shale oil in place totals approximately 110 million barrels if the Company's in situ extraction process is successful. Additional shale oil in place is substantial but could be recovered only if other processes are utilized by the Company or other companies during the remaining lease terms. Approximately 27,000 barrels of shale oil have been recovered through September 30, 1981.

In addition to the above-described leases the Company holds interests in oil shale mining claims covering approximately 10,000 acres in western Colorado. The U.S. Department of the Interior has initiated action to have all such claims cancelled. The outcome of such action has not yet been determined. However, the Supreme Court has ruled in favor of other companies in similar cases. The cost of these interests, $12,700 since inception, was charged to operations prior to 1978.

In September 1980, DOE awarded the Company a $1,886,000 grant to study the feasibility of shale oil production by conventional mining and surface retorting from a 22,000 acre lease block held by the Company. Work under the grant, which provides for 100% DOE funding, is expected to be completed during fiscal 1982. The work is being performed principally by independent engineers and consultants.

3. Property and Equipment

The Company holds 17 oil shale leases covering approximately 30,000 acres in northeastern Utah. The leases, which have initial terms expiring during 1983 through 1999, provide for minimum annual rentals plus production royalties as follows:

Acres	Minimum annual rentals[1]	Production royalties[2]
19,200	$225,000 in 1982 increasing to $450,000 in 1987 and thereafter[3]	6%
10,800	$11,000 in 1982 decreasing to $1,000 in 1999	5% for first 5 years: thereafter may be increased 1% per annum by lessor to maximum of 12½%

[1]The leases may be extended beyond their initial term as long as shale oil is being produced in commercial quantities.

[2]Royalties are based on the gross proceeds from sales of all products extracted from oil shale.

[3]Annual rentals in excess of $50,000 may be satisfied by expenditures for development work.

Office furniture and equipment are being depreciated principally using straight line methods over their useful lives which range from five to ten years.

The Company leases its principal offices in Salt Lake City. Annual rentals under the lease are $29,000 plus adjustments based on increases in the cost of living index through 1984. The Company also leases its office and warehouse premises in Vernal, Utah and laboratory facilities in Concord, California from the Company's president and his family. The leases have one year and month-to-month terms, respectively, and require annual rentals of approximately $13,000.

4. Income Taxes

Income taxes for 1979 represent statutory minimum California and Utah franchise taxes. Income taxes for 1980 include federal provisions of $6,600 offset by an extraordinary credit arising from realization of operating loss carryforwards from prior years. The remainder represents California and Utah franchise taxes. Income taxes for 1981 include Federal income tax provisions of $156,563 and state franchise tax provisions of $20,629. Income taxes vary from amounts derived by applying the Federal statutory rate to income (loss) before income taxes and extraordinary credit for the following reasons:

	1979	1980	1981
Tax provision (credit) computed at Federal statutory rate	$(25,067)	$ (9,400)	$197,101
Effect in 1980 of basis difference of assets contributed by joint venture partner in 1979		32,548	
Amortization of technical plans and other intangibles not deductible on tax returns	5,812		
Wages not deductible relating to new jobs tax credits	3,707		
New jobs, additional research and investment tax credits		(5,634)	(16,747)
Tax loss not recognized	5,861		
State franchise taxes net of Federal deduction effect	225	1,367	20,629
Surtax exemptions and other	9,687	(9,720)	(23,791)
Total	$ 225	$ 9,161	$177,192

5. Retirement Plan

The Company has a defined contribution retirement plan which covers substantially all employees. The Company is obligated to fund an annual contribution equivalent to 10% of the participants' compensation. The participants may, at their option, contribute up to an additional 10% of their compensation to the plan. Participants' interests in the Company's contributions vest ratably over five years.

The Company's police is to fund pension costs accrued. Pension expense was $48,500 in 1979, $60,400 in 1980, and $68,100 in 1981.

6. Stockholders' Equity

The Company was a California corporation from inception until April 1980 when it reincorporated in Delaware and split its stock 100 to 1. Retroactive effect has been given in the accompanying financial statements to the reincorporation and stock split.

Authorized capital consists of 5,000,000 shares of $.20 par value common stock of which 2,344,000 shares were issued and outstanding at September 30, 1979, and after the public offering of 450,000 shares during April 1980, 2,794,000 shares were issued and outstanding at September 30, 1980 and 1981. In 1969, 1,200,000 shares were issued to the founders of the Company for technical plans and other intangibles. These shares were valued at $300,000. The basis for such valuation was agreed to by the founders of the Company as part of a plan in which 2,400,000 shares were to have been issued—one half for $300,000 cash and the other half to the founders for their technical plans and other intangibles. The Company amortized the $300,000 of technical plans and other intangibles ratably over ten years from its inception through early 1979.

Assets contributed by the Company's joint venture partner consisted of the partner's interest in the joint venture assets (principally oil shale leases) at the time of the partner's withdrawal. The Company's basis in such assets is the cost of such assets to the joint venture.

At a special meeting during 1979, the shareholders granted common stock options, exercisable over a maximum of five years, for 199,800 shares to certain officers and a former employee. In January 1980, the exercise price of the options was increased to an amount equal to the public offering price of $7.50 and all of the options became exercisable after the public offering of the Company's common stock during April 1980. During February 1981, the shareholders approved an employee stock option plan authorizing the issuance of up to 150,000 shares exercisable over a maximum of ten years. During June 1981, the Company granted options under the plan to an officer for 65,000 shares. The options are exercisable over ten years at a price of $9.00 per share. At September 30, 1981, 85,000 shares are available for granting at not less than fair market value at date of grant. As of September 30, 1981, the 264,800 optioned shares had an aggregate quoted market value of $1,522,600 ($5.75 per share) and are exercisable at an aggregate option price of $2,083,500.

In connection with the Company's public offering of common stock during April 1980, a common stock purchase warrant was sold to the principal underwriter for $230. The warrant, which became exercisable April 30, 1981, covers an aggregate 23,000 shares of common stock and is exercisable at a price of $9 per share through April 1985.

7. Supplementary Operating Information

The following costs and expenses have been charged to operations for each of the three years ended September 30, 1981.

	1979	1980	1981
Maintenance and repairs	$14,894	$ 6,674	$ 5,768
Amortization of intangibles	12,500		
Taxes (other than payroll and income taxes)	20,515	10,644	8,495
Royalties	29,538	59,152	61,118

Charges for advertising were not material.

Opinion of Independent Certified Public Accountants

To the Board of Directors and Stockholders
of Geokinetics Inc.:

We have examined the statements of financial position of Geokinetics Inc. (a development stage company) as of September 30, 1980 and 1981, the related statements of operations and changes in financial position for each of the three years in the period ended September 30, 1981, and the statement of stockholders' equity for the three years ended September 30, 1981. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such financial statements present fairly the financial position of Geokinetics Inc. at September 30, 1980 and 1981, the results of its operations and the changes in its financial position for each of the three years in the period ended September 30, 1981, and its stockholders' equity for the three years ended September 30, 1981 in conformity with generally accepted accounting principles applied on a consistent basis.

November 20, 1981

HEMOKINETICS, INC.
Balance Sheets
(A Company in the Development Stage)

Assets

	JUNE 30, 1983	JUNE 30, 1982
Current Assets		
Cash	$ 175	$ 3,702
Investments (note B)	1,383,000	2,266,000
Accrued interest receivable	—	2,177
Advances	1,000	19,306
Income tax refund receivable (note I)	700	700
Prepaid expenses	1,949	—
Total current assets	1,386,824	2,291,885
Furniture and Office Equipment, net of accumulated depreciation of $3,858 in 1983 and $1,364 in 1982 (note A3)	8,521	7,730
Other Assets		
Technology license agreement, net of $27,500 accumulated amortization (note D)	—	272,500
Organization expenses, net of accumulated amortization of $1,472 in 1983 and $863 in 1982 (note A1)	1,575	2,184
Miscellaneous deposits	1,760	2,160
	3,335	276,844
	$1,398,680	$2,576,459

Liabilities

	1983	1982
Current Liabilities		
Bank overdraft	$ 4,335	$ —
Accounts payable	13,691	99,230
Accrued expenses	6,863	6,230
Total current liabilities	24,889	105,460
Commitments (note C)		
Stockholders' Equity (notes E and F) F)		
Common stock Class A $.01 par value, authorized 20,000,000 shares; issued and outstanding, 6,750,000 shares	67,500	67,500
Common stock, Class B, $.01 par value, authorized, issued, and outstanding 6,250,000 shares	62,500	62,500
Additional contributed capital	2,891,781	2,891,781
Deficit accumulated during the development stage	(1,647,990)	(550,782)
	1,373,791	2,470,999
	$1,398,680	$2,576,459

The accompanying notes are an integral part of these statements.

Statements of Operations

(A Company in the Development Stage)

From inception (September 23, 1980) through June 30, 1981 and each of the two years in the period ended June 30, 1983

	From inception (September 23, 1980) through June 30, 1981	Year ended June 30, 1982	Year ended June 30, 1983	From inception (September 30, 1980) through June 30, 1983
Interest income	$20,496	$ 299,078	$ 171,221	$ 490,795
General and administrative expenses	8,019	399,744	445,859	853,622
Other operating expenses	609	—	—	609
Research and development expenses	—	457,084	565,070	1,022,154
Write-off of technology license agreement (note D)	—	—	257,500	257,500
Earnings (loss) before income taxes	11,868	(557,750)	(1,097,208)	(1,643,090)
Income taxes (benefit)	5,600	(700)	—	4,900
Net Earnings (loss)	$ 6,268	$(557,050)	$(1,097,208)	$(1,647,990)
Earnings (loss) per common share (note H)	$ —	$(.04)	$(.08)	

The accompanying notes are an integral part of these statements.

Statements of Stockholders' Equity

(A Company in the Development Stage)

From inception (September 23, 1980) through June 30, 1981 and each of the two years in the period ended June 30, 1983.

	Common stock Class A	Common stock Class B	Additional contributed capital	Earnings (deficit) accumulated during the development stage
Initial issuance of stock (6,250,000 shares) at purchase price of $.05 per share	$ —	$62,500	$ 250,000	$ —
Initial issuance of stock (1,250,000 shares) at purchase price of $.05 per share	12,500	—	50,000	—
Net earnings from inception through June 30, 1981	—	—	—	6,268
Balance at June 30, 1981	12,500	62,500	300,000	6,268
Issuance of stock (5,500,000 shares) at purchase price of $.60 per share, net of expenses paid to underwriters of $442,500 and other costs of $210,819	55,000	—	2,591,681	—
Initial issuance of common stock purchase warrants (500,000 shares) at a purchase price of $100	—	—	100	—
Net operating loss for the year	—	—	—	(557,050)
Balance at June 30, 1982	67,500	62,500	2,891,781	(550,782)
Net operating loss for the year	—	—	—	(1,097,208)
Balance at June 30, 1983	$67,500	$62,500	$2,891,781	$(1,647,990)

The accompanying notes are an integral part of these statements.

Statements of Changes in Financial Position

(A Company in the Development Stage)

From inception (September 23, 1980) through June 30, 1981 and each of the two years in the period ended June 30, 1983

	From inception (September 23, 1980) through June 30, 1981	Year ended June 30, 1982	1983	From inception (September 30, 1980) through June 30, 1983
Uses of working capital				
Loss (earnings) from operations	$ (6,268)	$ 557,050	$1,097,208	$1,647,990
Charges to operations not using working capital				
Write-off of technology license agreement	—	—	(257,500)	(257,500)
Amortization	(254)	(28,109)	(15,609)	(43,972)
Depreciation	—	(1,364)	(2,494)	(3,858)
Working capital used (provided) by operations	(6,522)	527,577	821,605	1,342,660
Purchase of furniture and equipment	—	9,094	3,285	12,379
Purchase of technology license agreement	—	300,000	—	300,000
Payments of deferred financing costs	142,071	68,748	—	210,819
Payments of organization expenses	3,047	—	—	3,047
Payments of deposits	2,310	—	—	2,310
	147,428	377,842	3,285	528,555
	140,906	905,419	824,890	1,871,215
Sources of working capital				
Proceeds from sale of common stock	375,000	2,857,500	—	3,232,500
Proceeds from sale of warrants	—	100	—	100
Decrease in deposits	—	150	400	550
	375,000	2,857,750	400	3,233,150
Increase (Decrease) in Working Capital	234,094	1,952,331	(824,490)	1,361,935
Working capital at beginning of period	—	234,094	2,186,425	—
Working capital at end of period	$234,094	$2,186,425	$1,361,935	$1,361,935
Components of increase in working capital				
Increase (decrease) in current assets				
Cash	$ 874	$ 2,828	$ (3,527)	$ 175
Investments	365,000	1,901,000	(883,000)	1,383,000
Accrued interest receivable	4,702	(2,525)	(2,177)	—
Advances	—	19,306	(18,306)	1,000
Income tax refund receivable	—	700	—	700
Prepaid expenses	—	—	1,949	1,949
(Increase) decrease in current liabilities				
Bank overdraft	—	—	(4,335)	(4,335)
Accounts payable	(10,080)	(89,150)	85,539	(13,691)
Accrued expenses	(120,802)	114,572	(633)	(6,863)
Accrued income taxes	(5,600)	5,600	—	—
	$234,094	$1,952,331	$(824,490)	$1,361,935

The accompanying notes are an integral part of these statements.

Notes to Financial Statements

(A Company in the Development Stage)

June 30, 1983

Note A—Summary of Significant Accounting Policies

The Company was incorporated on September 23, 1980. The Company's initial capitalization included the sale of all 6,250,000 shares of the Class B common stock to ENSCO, Inc. Certain officers, directors, and employees of the Company have purchased 1,250,000 shares of the Company's Class A common stock.

Since inception, the Company's efforts have been devoted to the development of its principal products and raising capital. The Company has not received any revenues from the sale of its products or services. Accordingly, through the date of these statements, the Company is considered to be in the development stage and the accompanying financial statements represent those of a development stage enterprise.

A summary of the Company's significant accounting policies applied in the preparation of the accompanying financial statements follows:

1. *Other Assets—Organization Expenses*

Expenses incurred in connection with the formation of the Company have been capitalized and are being amortized over a period of five years on the straight-line method.

2. *Federal Income Taxes*

The Company filed a consolidated Federal income tax return with ENSCO in 1981. Beginning with fiscal year 1982, the Company files separate tax returns for Federal and state income tax purposes. Investment tax credits will be accounted for as a reduction to the provision for Federal income taxes in the year they reduce income taxes payable.

3. *Depreciation*

Depreciation is provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. Furniture and office equipment are being depreciated on an accelerated method over a period of 5 years.

Note B—Investments

The Company has invested the unused proceeds of its stock offerings in short-term government repurchase agreements.

Note C—Commitments

The Company has entered into various employment/consulting agreements with four of its stockholders/officers. These agreements call for aggregate annual payments of $191,000 through July 1983.

Note D—Technology License Agreement

On July 27, 1981, the Company entered into a technology license agreement with ENSCO, Inc. to pursue the development of various medical devices. Accordingly, the cost of the license agreement, $300,000, was capitalized and was being amortized over a ten-year life using the straight-line method. At December 31, 1982, the unamortized balance was written off. The Board of Directors determined that it was unlikely the Company would realize an economic return on its investment in light of the Company's current and anticipated product development direction.

Note E—Stock Options

In October 1982, the Company's Board of Directors approved a qualified stock option plan. Under this plan, employees, other than officers and directors, are eligible to participate. Options granted will be priced at not less than 100% of the fair market value of the stock on the date of the grant. The option price for stock granted to an eligible employee or director who possesses more than 10% of the total combined voting power of all classes of the common stock of the Company will not be less than 110% of the fair market value of the stock on the date of the grant. Fair market value is determined in accordance with the applicable regulations of the Internal Revenue Services. Options granted to a participant may only be exercised by that participant. Furthermore upon an option's termination or expiration in whole or in part for any cause, the option will again become available for future grants.

As of June 30, 1983, no options have been granted, but the Company has reserved 750,000 shares of the Company's Class A common stock for issuance under the plan.

Note F—Common Stock

The Company is authorized to issue 26,250,000 shares of common stock, par value $.01 per share. Of the 26,250,000 shares, 20,000,000 are Class A common stock and 6,250,000 are Class B common stock. Class A common stockholders are entitled to one vote per share on all matters to be voted on by stockholders. Class B common stockholders have no vote with respect to the election of directors to the Company's Board of Directors, but are entitled to one vote per share with respect to every other action upon which stockholders may vote. The holders of common stock, both Class A and B, are entitled to receive such dividends, if any, as may be declared from time to time by the Board of Directors in its discretion from funds legally available therefor. Upon liquidation or dissolution of the Company, the holders of common stock, both Class A and B, are entitled to receive pro rata all assets available for distribution to shareholders. The shares of Class B common stock are convertible, share for share, at the option of the Class B common stockholders, into shares of Class A common stock upon six months' written notice to the Board of Directors of the Company. In any event, all shares of Class B common stock issued and outstanding as of February 1, 1986, will be deemed to be shares of Class A common stock on that date without any further action on the part of the Class B common stockholders or the Company.

The Company sold the underwriter a warrant for $100. This warrant entitles the underwriter to purchase 500,000 shares of the Company's Class A common stock for a period of four years from July 27, 1981 at a price equal to 120% of the public offering price.

Note G—Related Party Transactions

The Company has entered into transactions with ENSCO, Inc., a principal stockholder. Under the terms of a technical services agreement, the Company paid ENSCO $100,000 during the twelve-month period ended July 27, 1982 for financial and scientific services. The Company has also contracted with ENSCO for various research and development activities. The Company paid ENSCO and subsidiary approximately $387,500 and $362,000 during the years ended June 30, 1983 and 1982, respectively. The Company had also entered into a technology license agreement with ENSCO (see note D).

Note H—Earnings Per Share

Earnings per common share have been computed using 13,000,000, 12,593,151 and 7,500,000, the weighted average number of shares outstanding during 1983, 1982 and 1981, respectively. Warrants have not been reflected in the earnings per share since they would be antidilutive.

Note I—Income Taxes

For the period ended June 30, 1981, the Company filed a consolidated Federal income tax return with its former parent company. Current income taxes payable for Federal and state purposes were $4,900 and $700, respectively. The Company filed separate returns for the years ended June 30, 1982 and 1983. No Federal taxes were due since the Company had an operating loss. A state tax benefit of $700 was realized in the year ended June 30, 1982 by a carryback of the net operating loss to 1981.

At June 30, 1983, the Company has unused net operating loss carryforwards of approximately $557,000 and $1,097,000 and tax credits of approximately $900 and $300, which expire in 1997 and 1998, respectively.

Auditor's Opinion

Board of Directors
Hemokinetics, Inc.

We have examined the balance sheets of Hemokinetics, Inc. (a District of Columbia corporation) as of June 30, 1983 and 1982, and the related statements of operations, stockholders' equity and changes in financial position from inception (September 23, 1980) through June 30, 1981 and for the years ended June 30, 1983 and 1982. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Hemokinetics, Inc., at June 30, 1983 and 1982, and the results of its operations and changes in its financial position from inception (September 23, 1980) through June 30, 1981 and for the years ended June 30, 1983 and 1982, in conformity with generally accepted accounting principles applied on a consistent basis.

August 16, 1983

MOHAWK PARTNERSHIP II, LTD.
Balance Sheet
(A Development Stage Enterprise)

ASSETS	December 31, 1981
Mine development costs (Note 1(c) and 2)	$198
Prepaid mine development costs (Note 2)	724
Advances to General Partner	2
Total Assets	$925
PARTNERS' EQUITY	
Limited partners contributions (Note 3)	$925

Partners' Equity
(A Development Stage Enterprise)

General Partner Limited Partners	December 31, 1981
Capital contributions (Note 3)	$925
Net income or (loss)	
Ending Capital Balances	$925

The accompanying notes are an integral part of this statement.

Notes to Financial Statement

(1) Summary of Significant Accounting Policies and General Information:

(a) Organization

Mohawk Partnership II, Ltd. (the Partnership), was formed June 30, 1981, under the Uniform Limited Partnership Act of the State of Nevada. The Veta Grande Companies, Inc. a Nevada Corporation, is the General Partner, and there are sixteen Limited Partners. An officer of The Veta Grande Companies, Inc. has limited partnership interest.

The Partnership was formed for the purpose of mining silver ore on property known as the Mohawk Mine which is owned by Mohawk Mines, Inc., a wholly owned subsidiary of the General Partner. The mine is located near Silver Peak, Nevada. The Partnership is currently in the development stage and has incurred no income or loss in its first six months of operation.

(b) Allocations Between General and Limited Partners

Net operating profits and taxable income will be allocated among the Partners on a quarterly basis as follows: fifty percent (50%) to the General Partner, and fifty percent (50%) to the Limited Partners until the Limited Partners have received a full payment of their cash capital contributions. Thereafter, when the Limited Partners have received profits equal to their respective cash contributions to the Partnership, the allocation shall be allocated seventy-five percent (75%) to the general Partner and twenty-five percent (25%) to the Limited Partners until such time as the allocation to the Limited Partners shall have completely discharged all full-recourse notes and accrued interest from the Limited Partners to the Partnership, thereafter, allocated eighty percent (80%) to the General Partner and twenty (20%) to the Limited Partners for the remainder of the term of this Partnership.

Net operating losses and taxable losses will be allocated on a quarterly basis as follows (1) five percent (5%) to the General Partner, and (2) ninety-five percent (95%) to the Limited Partners. Allocations will be on a quarterly basis rather than a cumulative basis.

(c) Development Costs and Depletion

Development costs are stated at cost. Depletion of development costs will be provided by the unit of production method, relating production of silver ore in each period to the aggregate estimated silver ore reserves.

(2) Development Costs:

The General Partner has been contracted by the Partnership to develop the mine at a cost of $925,000. As of December 31, 1981, the Partnership paid to the General Partner $925,000 of which $412,500 was paid in cash and $512,500 was paid by assigning to the General Partner promissory notes which were received from the Limited Partners. (See Note 3) As of December 31, 1981 the General Partner had incurred $198,182 in mine development expenditures, and expects to incur additional mine development cost of $726,818 during 1982.

(3) Limited Partners' Capital Contributions:

As of December 31, 1981, the Partnership received capital contributions from the Limited Partners in the amount of $925,000. The capital contributions represented cash of $412,500 and promissory notes in the amount of $512,500.

The full-recourse promissory notes are payable on demand and are due no later than June 29, 1987. These notes pay interest at the rate of 10%, payable annually on June 29 of each year starting in 1982. These notes are secured by irrevocable letters of credit. All notes were assigned to the General Partner. (See Note 2.)

(4) Mining Revenue and Costs:

The Partnership has the right to mine ore from the General Partner's existing mine up to 30 tons of ore per day (noncumulative) during the life of the Partnership. The General Partner has guaranteed the Partnership at least twelve (12) ounces of recoverable silver per ton of ore mined, and will pay the Partnership 91½% of the current market value for the silver.

The Partnership has agreed to pay to the General Partner a $75.00 per ton fee to cover the mining costs: if the price of silver is more than $10.00 per ounce then the per ton fee will be increased to $100.00.

Accountants' Report

General Partner, Mohawk Partnership II, Ltd.
Reno, Nevada

We have examined the balance sheet of Mohawk Partnership II, Ltd., at December 31, 1981, and the related statements of partners' equity for the period from July 1 through December 31, 1981. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Mohawk Partnership II, Ltd., at December 31, 1981, in conformity with generally accepted accounting principles.

March 9, 1982

XICOR, INC.
Statement of Operations
(A Company in the Development Stage)

	Year Ended			August 18, 1978 (Inception) through
	December 31, 1979	December 31, 1980	January 3, 1982	January 3, 1982
Sales (Note 1)	$ —	$ 69,000	$ 347,000	$ 416,000
Interest income	21,000	471,000	1,550,000	2,042,000
	21,000	540,000	1,897,000	2,458,000
Costs and expenses:				
Research and development	120,000	478,000	2,541,000	3,148,000
Marketing, general, administrative, cost of sales and start-up costs (Note 1)	245,000	932,000	4,584,000	5,772,000
Interest expense		3,000	298,000	301,000
	365,000	1,413,000	7,423,000	9,221,000
Net loss (Note 9)	$ (344,000)	$ (873,000)	$(5,526,000)	$(6,763,000)
Net loss per common share (Note 11)	$ (.14)	$ (.30)	$ (.95)	$ (1.40)
Average common shares outstanding (Note 11)	2,400,000	2,956,000	5,826,000	4,830,000

See accompanying notes to financial statements.

Balance Sheets

(A Company in the Development Stage)

Assets

	December 31, 1980	January 3, 1982
Current assets:		
Cash	$ 57,000	$ 58,000
Certificates of deposit (including interest receivable of $153,000 and $62,000)	13,600,000	4,012,000
Short-term investments (Note 10)	1,647,000	1,062,000
Accounts receivable	25,000	142,000
Inventories (Note 3)	24,000	172,000
Prepaid expenses and other current assets	32,000	156,000
Total current assets	15,385,000	5,602,000
Property, plant and equipment, at cost less accumulated depreciation (Note 4)	960,000	11,068,000
Patents	104,000	120,000
Other assets	44,000	155,000
	$16,493,000	$16,945,000

Liabilities and Shareholders' Equity

	December 31, 1980	January 3, 1982
Current liabilities:		
Accounts payable	$ 1,187,000	$ 1,314,000
Accrued wages and employee benefits	24,000	145,000
Other accrued expenses	12,000	212,000
Current portion of obligations under capital leases (Note 8)	1,000	158,000
Total current liabilities	1,224,000	1,829,000
Notes payable to shareholders	24,000	24,000
Convertible promissory note (Notes 4 and 6)		2,873,000
Obligations under capital leases (Note 8)	8,000	2,318,000
Accrued compensation related to stock options (Note 7)		190,000
Commitments (Notes 8 and 12)		
Shareholders' equity (Notes 2, 5, 6 and 7):		
Preferred stock; 5,000,000 shares authorized		
Common stock; 15,000,000 shares authorized; 5,826,398 shares and 5,826,448 shares outstanding	16,474,000	16,474,000
Deficit accumulated during the development stage	(1,237,000)	(6,763,000)
	15,237,000	9,711,000
	$16,493,000	$16,945,000

See accompanying notes to financial statements.

Statement of Shareholders' Equity
(A Company in the Development Stage)

August 18, 1978 (Inception) through January 3, 1982

	Preferred Stock		Common Stock		Deficit Accumulated During the Development Stage	Total
	Number of Shares	Amount	Number of Shares	Amount		
Issuance in November 1978, for cash, to founders			2,400,000	$ 20,000	$ —	$ 20,000
Net loss					(20,000)	(20,000)
Balance at December 31, 1978			2,400,000	20,000	(20,000)	—
Issuance in February through June, for cash, of Non-cumulative Series A Convertible, net of issuance costs of $2,000 (Note 5)	404,790	$ 476,000				476,000
Issuance in December, for cash, of Non-cumulative Series A Convertible (Note 5)	105,152	400,000				400,000
Net loss					(344,000)	(344,000)
Balance at December 31, 1979	509,942	876,000	2,400,000	20,000	(364,000)	532,000
Issuance in April and May, for cash, of Non-cumulative Series A Convertible (Note 5)	548,764	2,087,000				2,087,000
Issuance in October to public investors, net of issuance costs of $276,000			1,980,000	11,050,000		11,050,000
Issuance in October, for cash, to affiliated company (Note 2)			80,000	520,000		520,000
Conversion in October of preferred stock into common stock (Note 5)	(1,058,706)	(2,963,000)	1,058,706	2,963,000		
Issuance in December, for cash, to an investment company, net of issuance costs of $79,000 (Note 6)			307,692	1,921,000		1,921,000
Net loss					(873,000)	(873,000)
Balance at December 31, 1980			5,826,398	16,474,000	(1,237,000)	15,237,000
Issuance of common stock upon exercise of stock options			50			
Net loss					(5,526,000)	(5,526,000)
Balance at January 3, 1982	—	$ —	5,826,448	$16,474,000	$(6,763,000)	$ 9,711,000

See accompanying notes to financial statements.

Statement of Changes in Financial Position
(A Company in the Development Stage)

	Year Ended December 31, 1979	Year Ended December 31, 1980	Year Ended January 3, 1982	August 18, 1978 (Inception) through January 3, 1982
Working capital provided by:				
Issuance of common stock		$13,491,000		$13,511,000
Issuance of preferred stock (Note 5)	$876,000	2,087,000		2,963,000
Increase in notes payable to shareholders	12,000			24,000
Issuance of convertible promissory note			$ 2,873,000	2,873,000
Increase in obligations under capital leases, net		8,000	2,363,000	2,371,000
	888,000	15,586,000	5,236,000	21,742,000
Working capital used for:				
Operations:				
Net loss for the period	344,000	873,000	5,526,000	6,763,000
Less: Depreciation	(3,000)	(9,000)	(304,000)	(316,000)
Accrued compensation expense related to stock options			(190,000)	(190,000)
Working capital used for operations	341,000	864,000	5,032,000	6,257,000
Acquisition of property, plant and equipment, net	19,000	947,000	10,412,000	11,384,000
Patents	12,000	89,000	16,000	120,000
Other assets	10,000	34,000	111,000	155,000
Reduction in obligations under capital leases			53,000	53,000
	382,000	1,934,000	15,624,000	17,969,000
Increase (decrease) in working capital	$506,000	$13,652,000	$(10,388,000)	$ 3,773,000
Changes in components of working capital:				
Increase (decrease) in current assets:				
Cash	$408,000	$ (355,000)	$ 1,000	$ 58,000
Certificates of deposit		13,600,000	(9,588,000)	4,012,000
Short-term investments	170,000	1,477,000	(585,000)	1,062,000
Accounts receivable		25,000	117,000	142,000
Inventories		24,000	148,000	172,000
Prepaid expenses and other current assets	6,000	23,000	124,000	156,000
	584,000	14,794,000	(9,783,000)	5,602,000
(Increase) decrease in current liabilities:				
Accounts payable	(47,000)	(1,136,000)	(127,000)	(1,314,000)
Accrued wages and employee benefits	(20,000)	(4,000)	(121,000)	(145,000)
Other accrued expenses	(11,000)	(1,000)	(200,000)	(212,000)
Current portion of obligations under capital leases		(1,000)	(157,000)	(158,000)
	(78,000)	(1,142,000)	(605,000)	(1,829,000)
Increase (decrease) in working capital	$506,000	$13,652,000	$(10,388,000)	$ 3,773,000

See accompanying notes to financial statements.

Notes to Financial Statements

(A Company in the Development Stage)

Note 1—The Company and Its Significant Accounting Policies

Xicor, Inc. (Xicor) was incorporated in California on August 18, 1978 to engage in the development, manufacture and sale of semiconductor devices.

Since inception, Xicor has been in the development stage. Through January 3, 1982 its operations have been in the design and development of semiconductor devices, the development of channels of distribution and the start-up of its manufacturing facility in California. To date all manufacturing of its products has been performed by Ebauches Electroniques S.A., Xicor's European licensee (see Note 2). Through January 3, 1982 sales of Xicor's products have been nominal, principally for evaluation, testing and for inclusion in prototype production by prospective customers. In late 1981 production was started at Xicor's manufacturing facility and deliveries of products manufactured in California are expected to commence in the second quarter of 1982.

Effective with the current year Xicor changed its accounting period from a calendar year to a 52 or 53-week year ending on the Sunday nearest December 31.

Xicor has adopted accounting practices which are generally accepted in the industry in which it operates. Following are the Company's accounting policies:

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market.

Sales to Distributors

Certain of Xicor's sales are made to distributors under agreements allowing rights of return and price protection on unsold merchandise. Such sales are not recognized until the merchandise is sold by the distributors. Amounts billed to the distributors but uncollected are included as accounts receivable and the related gross profit is deferred and reflected as a current liability.

Property and Equipment

Depreciation is computed using the straight-line method and the assets estimated useful lives of five to eight years. Amortization of the capitalized leased building and building improvements and of leasehold improvements is computed over the shorter of the remaining terms of the leases or the estimated useful lives of the improvements.

License and Royalty Income Recognition

Income resulting from the licensing of Xicor products to other manufacturers is recognized when the related contractual obligations have been fulfilled and fees are billable under the terms of the agreements. Royalty income is recognized upon the reported sale of product subject to royalties.

Loss Per Common Share

Loss per common share is based on the weighted average number of common shares outstanding.

Income Taxes

Investment and research and development tax credits are recognized as a reduction of the provision for Federal income taxes to the extent allowable, as measured by income for financial reporting purposes, in the year the related assets are placed in service or the qualified research and development expenditures are incurred.

Patents

Costs incurred in acquiring patents are amortized on a straight-line basis over the life of the patent or the estimated useful life of the patented process, whichever is shorter.

Note 2—Related Party Transactions

In January 1979 and April 1980, Xicor entered into agreements with a Swiss company, Ebauches Electroniques S.A. (Ebauches), which provide that firm with an exclusive license to manufacture and sell in Europe all devices developed by Xicor through April 1986. The agreements expire in January 1994 unless extended.

The agreements provide that, until such time as Xicor has an operational manufacturing facility, it may purchase up to 65% of Ebauches' production of Xicor products for completion by other subcontractors and sale to its customers. Subsequent to the completion of its manufacturing facility, Xicor has the right to continue to purchase a portion of Ebauches' production to the extent that such purchases will make available to Xicor a maximum of 65% of the combined production of the companies. Purchase prices will be determined from time-to-time through negotiation.

Sales to third parties of Xicor products by Ebauches are subject to royalties at the following rates: 5% of sales until cumulative sales have reached $30,000,000; 2½% of sales thereafter. When Xicor has earned $750,000 in royalties, the minimum quarterly royalty payment will be $50,000. The foregoing royalty rates are subject to renegotiation by mutual agreement of the companies. Sales under these agreements through January 3, 1982 have been insignificant.

Additional terms of the agreements stipulate that each company is the other's official second source in their respective worldwide markets; provide for automatic cross-licensing of any new products utilizing Xicor technology developed by Ebauches; and provide for modification of the terms of the agreements in the event of a significant change in ownership (e.g. acquisition or merger) of either firm.

In April 1980, Ebauches S.A. (parent company of Ebauches) purchased 525,767 shares of Noncumulative Series A Convertible preferred stock for $2,000,000. In October 1980, these shares were converted into 525,767 shares of common stock (see Note 5). In October 1980, the parent company of Ebauches S.A. purchased 80,000 additional shares of common stock for $520,000 and at January 3, 1982 Ebauches S.A. and its parent company owned 10.4% of the outstanding common stock of the Company. Ebauches S.A. has the right until April 1985 to acquire from Xicor, at the then offered price and terms, additional common stock sufficient to give Ebauches S.A. and its affiliates a 15% ownership interest in Xicor.

During 1980 and 1981, Xicor paid Ebauches approximately $90,000 and $1,900,000, respectively, for use of Ebauches' production facilities for development of new Xicor products, assistance with the start-up of Xicor's production facility in California and for raw materials and NOVRAM memories shipped to Xicor.

During each of the two years ended January 3, 1982 Xicor had consulting agreements with certain members of the Board of Directors resulting in a charge to operations of $63,000 and $69,000 in 1980 and 1981, respectively.

Note 3—Inventories

Inventories comprise the following:

	December 31, 1980	January 3, 1982
Raw materials and supplies		$ 123,000
Work in process and finished goods	$ 24,000	49,000
	$ 24,000	$ 172,000

Note 4—Property, Plant and Equipment:

Property, plant and equipment consisted of the following:

	December 31, 1980	January 3, 1982
Leased building and building improvements		$ 1,602,000
Leasehold improvements		2,607,000
Equipment	$105,000	5,500,000
Furniture and fixtures	15,000	133,000
Construction in progress	851,000	1,541,000
	971,000	11,383,000
Less accumulated depreciation	(11,000)	(315,000)
	$960,000	$11,068,000

In April 1981 Xicor took possession of its new leased manufacturing facility. The terms of the lease, which expires in April 1996, provide for minimum monthly payments of $32,000 over the lease term. Subsequent to March 1987 the monthly rental is subject to escalation based on changes in the Consumer Price Index. The portion of the lease allocable to the building and improvements has been accounted for as a capital lease which resulted in the recording of an asset and related lease obligation of $1,602,000 and portion of the lease payments allocable to the land ($8,000 per month) are charged to operations as incurred (see Note 8).

Equipment with a net book value of approximately $4,300,000 at January 3, 1982 is pledged as security for the Convertible Promissory Note payable to CIN Industrial Investments, Ltd. (see Note 6).

Note 5—Preferred Stock:

The Articles of Incorporation of Xicor presently provide for 5,000,000 shares of preferred stock. No shares of preferred stock are presently outstanding. The shares of Non-cumulative Series A Convertible preferred previously issued were, upon the sale of common stock to public investors in October 1980, converted into common stock on a share for share basis.

Note 6—Common Stock:

In August 1980, the shareholders approved an amendment to the Articles of Incorporation to increase the number of authorized shares from 5,000,000 to 15,000,000.

In December 1980, Xicor sold 307,692 shares of common stock to CIN Industrial Investments, Ltd. ("CIN"), a wholly-owned subsidiary of the National Coal Board Pension Funds of the United Kingdom, CIN also provided a commitment to loan up to $4,000,000 to Xicor for the purchase of production and testing equipment. The loans, to be advanced upon Xicor's request to finance two-thirds of the cost of the equipment, are evidenced by convertible notes bearing interest at a floating rate 2.5% above the Bank of America's prime rate, are repayable on December 31, 1987 and are collateralized by a security interest in the equipment purchased. These notes may be prepaid in whole or in part without penalty at any time after January 1, 1982, provided that until December 31, 1985 prepayment may only be made with the consent of CIN. Under the terms of the note, CIN will have the right, during the four-year period from January 1, 1982 through December 31, 1985, to acquire Xicor common stock to the full amount of the $4,000,000 commitment through conversion of the note, or if there is insufficient principal outstanding through direct purchase from Xicor at the following prices: $16 per share during 1982; $22.50 per share during 1983; $30 per share during 1984; and $45 per share during 1985; or at 80% of the market price at the time of conversion or purchase, whichever is lower, but in no event lower than $16 per share, subject to antidilution provisions. However, Xicor has the right, at December 31, 1985, to require the conversion of up to $275,000 of outstanding loans into common stock.

The note also grants CIN registration rights for all shares acquired pursuant to the terms of the note; in addition, CIN will receive similar registration rights for its initial 307,692 shares in the event CIN acquires at least $1,500,000 of Xicor's common stock pursuant to the terms of the note. Xicor has reserved 250,000 shares of common stock for issuance upon conversion of future notes to common stock.

In November 1981 Xicor borrowed $2,873,000 under this loan commitment, which loan carried an interest rate of 18¼% at January 3, 1982. Xicor borrowed the balance available under this loan commitment in early 1982.

Note 7—Stock Option and Warrant Arrangements:

In November 1979, the Board of Directors adopted the Xicor, Inc. Nonqualified Stock Option Plan which was approved by the shareholders in March 1980. The plan was amended in December 1981, subject to shareholder approval, to permit the granting of both incentive stock options and nonincentive stock options as provided by the Economic Recovery Tax Act of 1981. Under the terms of the Plan, the Board may grant options to Xicor employees to purchase common stock of Xicor at the fair value at date of grant (as determined by the Board of Directors) for incentive stock options and at not less than 85% of the fair value for non-incentive options. Options generally become exercisable in 25% annual increments. Unexercised options expire five years from the date of grant.

Subsequent to the above mentioned modification in the Plan and prior to January 3, 1982, non-qualified options for 309,189 shares were converted to incentive stock options at prices ranging from $1.25 to $6.54 per share (an average of $5.85, which compares to an average price of $5.31 for the original non-qualified options). All other options previously granted under the 1979 plan do not qualify as incentive options.

Options to purchase unregistered stock granted to employees during 1981 were granted at the fair value as determined by the Board of Directors which was less than the traded value of Xicor's registered common stock at the date of grant. The difference between the fair value of the stock as determined by the Board and the traded value at date of grant will be recorded as compensation expense. Should all employees who received stock options during 1981 remain in Xicor's employ for the entire four-year vesting period of the options, Xicor would record maximum compensation expense related to these options of approximately $1,090,000 over such four-year period. Of this amount, compensation expense totaling $190,000 has been charged to operations during 1981.

The Board from time to time has also granted options to non-employees to purchase common stock of Xicor at $.05 and $.10 per share. These options are exercisable three years from the date of grant if certain conditions are met.

In June 1981 the shareholders approved an increase from 420,000 to 1,400,000 in the number of shares which may be issued to employees under the Xicor stock option plan. At December 31, 1980 and January 3, 1982, 268,500 and 837,910 options, respectively, were available for future grant under all option arrangements.

The following table summarizes the status and activity under all stock option arrangements:

	Options	Option Price	Average Option Price
Options granted (adjusted for incentive option conversion):			
Employees—			
1980	85,326	$1.25 to 5.50	$4.45
1981	477,464	5.50 to 6.54	5.95
Non-employees—			
1979	6,400	.05 and .10	.056
1980	2,400	.10	.10
Options cancelled in 1981	(750)	5.50	5.50
Options exercised in 1981	(50)	5.50	5.50
Options outstanding at January 3, 1982	570,790		$5.64

At January 3, 1982, options for 43,375 shares were exercisable at prices of $1.25 to $6.50 (an average of $4.69). The remaining options will become exercisable as follows: 1982—146,898; 1983—142,898; 1984—135,247 and 1985—102,372. As of January 3, 1982, all shares to be issued under the stock option plan will be "unregistered shares".

In connection with the sale of common stock to public investors in October 1980, Xicor sold to the underwriter 180,000 warrants at $.001 per warrant for the purchase of 180,000 shares of common stock prior to October 31, 1985 at a price of $7.80 per share. These warrants are exercisable at January 3, 1982. The exercise price and the number of shares issuable upon exercise of the warrants are subject to adjustment in certain instances to protect against dilution. Xicor has agreed, if requested by a majority of the holders of the warrants and/or underlying shares of common stock prior to October 31, 1985, to permit the public offering at Xicor's expense of the shares of common stock underlying the warrants, and has further agreed to include the shares underlying the warrants in the first registration statement which Xicor may file during such four-year period.

Note 8—Leasing Arrangements:

Xicor leases its facility and certain equipment under non-cancellable lease agreements. Leases which meet certain specific criteria are accounted for as the acquisition of an asset and the incurrence of a liability (i.e., a "capital lease"). See Note 4 for a description of the building and building improvements lease obligation. The equipment leases are for a term of five years and require Xicor to pay property taxes, insurance and certain maintenance and repair costs. In addition, the investment tax credit has been retained by the lessor.

Assets recorded under capital leases were as follows:

	December 31, 1980	January 3, 1982
Building and building improvements		$1,602,000
Equipment	$10,000	921,000
	10,000	2,523,000
Less accumulated depreciation	(1,000)	(103,000)
	$ 9,000	$2,420,000

Minimum future lease payments under all non-cancellable leases as of January 3, 1982 were as follows:

	Capital Leases	Land Lease
Years:		
1982	$ 536,000	$ 102,000
1983	570,000	102,000
1984	570,000	102,000
1985	565,000	102,000
1986	480,000	102,000
1987-1991	1,436,000	508,000
1992-1996	1,215,000	440,000
Total minimum lease payments	5,372,000	$1,458,000
Less amount representing interest	(2,896,000)	
Present value of minimum lease payments	2,476,000	
Less current portion	(158,000)	
Long-term lease obligation	$2,318,000	

Total rental expense under all non-capitalized leases for the three years ended January 3, 1982 was as follows (including month-to-month rentals): 1979—$11,000; 1980—$87,000; 1981—$113,000.

Note 9—Income Taxes:

At January 3, 1982 Xicor had net operating loss carryforwards of approximately $7,000,000 for tax reporting purposes. These carryforwards, which are available to offset future income otherwise taxable, expire in varying amounts, principally in 1996. Xicor has recognized expenses totaling approximately $500,000 for tax reporting purposes in excess of amounts recorded for financial reporting purposes, resulting principally from the utilization of accelerated depreciation methods. At January 3, 1982, approximately $550,000 of tax credit carryforwards are available for tax and financial reporting purposes to reduce income taxes otherwise payable; such carryforwards expire in varying amounts, principally in 1996.

Note 10—Short-Term Investments:

Short-term investments in United States government treasury bills and in various liquid asset funds are carried at cost, which approximates market.

Note 11—Loss Per Common Share:

All common share equivalents (options on common stock, common stock purchase warrants and Non-cumulative Series A Convertible preferred stock through date of conversion) have been excluded from the computations in that their inclusion would have decreased the net loss per common share.

Note 12—Royalty and Purchase Commitments:

In June 1980, Xicor entered into a licensing agreement with Intel Corporation. The agreement grants Xicor and its qualified assignees licenses under certain patents held by Intel Corporation. Sales of products utilizing these patents by Xicor and its assignees will be subject to royalties at the following rates: 2½% of sales until royalties of $275,000 have been paid; 1½% of sales thereafter until aggregate royalties of $475,000 have been paid.

At January 3, 1982, Xicor had entered into various commitments for the purchase of equipment providing for payments of approximately $850,000.

Note 13—Event Subsequent to Date of the Report of Independent Accountants (Unaudited):

On March 26, 1982, Xicor filed a registration statement with the Securities and Exchange Commission for the sale of 8000 units of its securities, each unit consisting of $1,000 principal amount of Convertible Subordinated Debentures due 1997 plus common stock. The interest rate and the conversion price of the debentures, and the number of shares of common stock to be included in each unit are yet to be determined. In certain circumstances, Xicor will have the right to redeem the debentures.

Property, Plant and Equipment
Schedule V

Classification	Balance at Beginning of Period	Additions at Cost		Retire-ments	Reclassi-fication	Balance at End of Period
Year ended December 31, 1980:						
Construction in progress—leasehold improvements		$ 240,000				$ 240,000
Equipment	$ 20,000	89,000		$(4,000)		105,000
Construction in progress—equipment		611,000				611,000
Furniture and fixtures	5,000	10,000				15,000
	$ 25,000	$ 950,000	(1)	$(4,000)	—	$ 971,000
Year ended January 3, 1982:						
Leased building and building improvements		$ 1,602,000				$ 1,602,000
Leasehold improvements		2,367,000			$240,000	2,607,000
Construction in progress—leasehold improvements	$240,000				(240,000)	—
Equipment	105,000	5,395,000				5,500,000
Construction in progress—equipment	611,000	930,000				1,541,000
Furniture and fixtures	15,000	118,000				133,000
	$971,000	$10,412,000	(1)	$(4,000)	—	$11,383,000

(1) See Notes 4 and 8 of Notes to Financial Statements for information regarding the financing of certain additions.

Accumulated Depreciation of Property, Plant and Equipment
Schedule VI

Classification	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Retire-ments	Balance at End of Period
Year ended December 31, 1980:				
Equipment	$ 3,000	$ 8,000	$(1,000)	$ 10,000
Furniture and fixtures		1,000		1,000
	$ 3,000	$ 9,000	$(1,000)	$ 11,000
Year ended January 3, 1982:				
Leased building and building improvements		$ 74,000		$ 74,000
Leasehold improvements		48,000		48,000
Equipment	$10,000	173,000		183,000
Furniture and fixtures	1,000	9,000		10,000
	$11,000	$304,000	—	$315,000

Report of Independent Accountants

To the Shareholders and
Board of Directors of Xicor, Inc.

In our opinion, the financial statements listed in the accompanying index present fairly the financial position of Xicor, Inc. (a company in the development stage) at December 31, 1980 and January 3, 1982, and the results of its operations and the changes in its financial position for each of the three years in the period ended January 3, 1982, and the period August 18, 1978 (inception) through January 3, 1982, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

February 12, 1982

III

OPERATING DEVELOPMENT STAGE ENTERPRISES

Six examples of development stage enterprises that apparently have commenced principal operations are presented below. The examples are classified according to whether or not the independent accountant expressed an opinion with a "subject to" qualification.

OPINION WITH "SUBJECT TO" QUALIFICATION

ARABIAN SHIELD DEVELOPMENT COMPANY

Statements of Changes in Financial Position
(A Company in the Development Stage)
For The Three Years Ended December 31, 1982
And Cumulative From Inception (May 4, 1967) To December 31, 1982

	1982	1981	1980	Cumulative From Inception (May 4, 1967) to December 31, 1982
Sources of Working Capital:				
Common stock issued for cash	$2,390	$1,840	$4,630	$12,810
Common stock issued for assets				958
Common stock issued in satisfaction of debt and for services rendered				361
Common stock issued upon conversion of debentures				350
Common stock issued upon exercise of warrants				320
Issuance of long-term debt				802
Proceeds from sales of oil and gas properties and Inlet Oil Corporation common stock				294
Carrying value of property interest transferred				62
Decrease in cash in Saudi Arabia		519		1,133
Increase in accrued liabilities in Saudi Arabia				250
Increase in noncurrent accrued interest				77
Other—net				134
Total sources of working capital	2,390	2,359	4,630	17,558

Applications of Working Capital:				
For operations:				
Net loss	34	23	58	1,617
Deduct items not affecting working capital:				
Depreciation and depletion		(1)	(2)	(391)
Loss on property and project abandonments				(792)
Loss resulting from rescission of a sale				(49)
Write-down of investment				(28)
Total for operations	34	22	56	355
Additions to mineral exploration and development costs	363	420	1,523	6,700
Increase in interest in Al Masane Project	1,401	2,071	1,402	4,875
Acquisition of undeveloped and developed oil and gas properties				1,307
Payments and transfer to current maturities of long-term debt				452
Increase in cash in Saudi Arabia	613		1,424	2,901
Decrease in accrued liabilities in Saudi Arabia	10	1	62	74
Conversion of debentures for common stock				350
Reduction of noncurrent interest				77
Investment in Inlet Oil Corporation common stock				118
Cost of rescission of a sale of a 15% interest in the Saudi Arabian project				100
Common stock and note issuance expense				100
Other property additions, etc.				172
Total applications of working capital	2,422	2,515	4,469	17,584
Increase (Decrease) in Working Capital	$ (32)	$ (156)	$ 160	$ (26)
Increase (Decrease) in Working Capital by Component:				
Cash in United States	$ (12)	$ (130)	$ 133	$ 29
Other current assets	(8)	3	(2)	8
Accounts payable		4	15	(19)
Accrued liabilities	(12)	(33)	14	(45)
Increase (Decrease) in Working Capital	$ (32)	$ (156)	$ 160	$ (26)

See Notes to Financial Statements.

Balance Sheets

(A Company in the Development Stage)

December 31, 1982 and 1981

Assets	1982	1981
Current Assets:		
Cash in United States	$ 29	$ 42
Other	8	16
Total current assets	37	58
Cash in Saudi Arabia (Note 2)	1,767	1,154
Mineral Exploration and Development Costs (Notes 1, 2, and 3)	6,700	6,337
Interest in Al Masane Project (Note 3)	4,875	3,473
Other Assets (Note 1)	4	4
Total	$13,386	$11,029

Liabilities		
Current Liabilities:		
Accounts payable	$ 19	$ 19
Accrued liabilities	45	33
Total current liabilities	64	52
Accrued Liabilities in Saudi Arabia (Note 2)	176	187
Commitments and Contingent Liabilities (Note 6)		
Stockholders' Equity (Notes 1 and 4):		
Common stock, par value $.10 (authorized 10,000,000 in 1982 and 7,000,000 in 1981; issued and outstanding, 6,417,494 in 1982 and 6,017,494 in 1981)	641	601
Additional paid-in capital	14,310	11,950
Notes receivable from stockholders	(190)	(180)
Deficit accumulated in the development stage	(1,617)	(1,582)
Stockholders' equity	13,145	10,789
Total	$13,386	$11,029

See Notes to Financial Statements.

Statements of Operations

(A Company in the Development Stage)

For The Three Years Ended December 31, 1982

And Cumulative From Inception (May 4, 1967) To December 31, 1982

	1982	1981	1980	Cumulative From Inception (May 4, 1967) to December 31, 1982
Revenues—Oil and gas sales	$ 20	$ 24	$ 20	$ 1,479
Operating Costs and Expenses:				
Lease operating expenses (including gross production and windfall profits taxes)	12	12	11	701
Depreciation and depletion (Note 1)			2	391
General and administrative expenses (Notes 2 and 3)	146	169	115	1,308
Loss on property and project abandonments				792
Total	158	182	129	3,193
Operating Loss	(137)	(158)	(108)	(1,714)
Income Credits (Charges):				
Interest income	110	182	49	342
Interest expense				(249)
Loss resulting from foreign currency translation	(12)	(48)		(60)
Loss resulting from rescission of a sale				(49)
Loss resulting from write-down of investment				(28)
Gain resulting from property interest transferred in satisfaction of accrued interest				41
Gain on sale of assets	5			101
Net Loss	$ (34)	$ (23)	$ (58)	$(1,617)
Per Share Data (Note 1):				
Net Loss	$ (.01)	$ (.00)	$ (.01)	
Average shares outstanding	6,102	5,808	4,843	

See Notes to Financial Statements.

Statements of Stockholders' Equity

(A Company in the Development Stage)

For The Period From Inception (May 4, 1967) To December 31, 1982

	Common Stock			Additional Paid-In Capital	Notes Receivable From Stockholders	Deficit Accumulated in the Development Stage	Total
	Amount Per Share	Shares	Amount				
Common stock issued (Note 4):							
1967	$ .25	75	$ 7	$ 11			$ 18
1974	2.00	600	60	1,140			1,200
	.25	7		1			1
1975	2.00	100	10	190			200
1976	2.00	600	60	1,140			1,200
1978	2.00	665	66	1,263			1,330
1980	2.50	275	27	660			687
	2.75	50	5	132			137
	3.00	115	11	333			345
	4.00	865	86	3,373			3,460
1981	2.00	100	10	190	$(180)		20
	4.00	255	25	994			1,020
	5.00	100	10	490			500
	6.00	50	5	295			300
1982	6.00	400	40	2,360	(30)		2,370
Collection of note receivable from shareholder—1982					20		20
Total		4,257	425	12,574	(190)		12,810
Common stock issued upon conversion of debentures—1976	1.00	350	35	315			350
Common stock issued upon exercise of warrants:							
1976	.86	139	13	106			120
	1.00	153	15	137			153
1978	1.00	46	4	42			46
Total		339	33	286			320
Common stock issued for assets:							
1967—for producing oil and gas properties	3.55	928	92	236			329
1969—for Alaska permits	8.00	9	1	72			73
	2.50	25	2	60			63
1971—for Inlet Oil Corporation stock	2.50	52	5	112			118
Total		1,015	101	482			583

Common stock issued for acquisition of subsidiary in a pooling-of-interests transaction—1971		255	25	349			375
Common stock issued in satisfaction of debt and for services rendered:							
1968	.25	6	1				1
1969	1.75	121	12	200			212
1970	5.00	1		4			5
1975	2.00	44	4	84			88
1976	2.00	1		3			3
1978	2.00	25	2	47			50
Total		199	19	341			361
Amount assigned to common stock purchase warrants:							
1971				1			1
1973				30			30
Total				31			31
Common stock issuance expense—1974				(70)			(70)
Deficit accumulated in the development stage...........						$(1,617)	(1,617)
Balance, December 31, 1982..		6,417	$641	$14,310	$(190)	$(1,617)	$13,145
Year Ended December 31, 1980:							
Balance, January 1, 1980..................		4,207	$420	$ 5,481		$(1,499)	$ 4,402
Common stock issued for cash (Note 4)..................................		1,305	130	4,499			4,630
Net loss for the year.....................						(58)	(58)
Balance, December 31, 1980...........		5,512	551	9,981		(1,558)	8,973
Year Ended December 31, 1981:							
Common stock issued for cash and note receivable (Note 4)		505	50	1,969	$(180)		1,840
Net loss for the year.....................						(23)	(23)
Balance, December 31, 1981...........		6,017	601	11,950	(180)	(1,582)	10,789
Year Ended December 31, 1982:							
Common stock issued for cash and note receivable....................		400	40	2,360	(30)		2,370
Collections from stockholder					20		20
Net loss for the year (Note 4)						(34)	(34)
Balance, December 31, 1982...........		6,417	$641	$14,310	$(190)	$(1,617)	$13,145

See Notes to Financial Statements.

Notes to Financial Statements

(A Company in the Development Stage)

1. Accounting Policies

History—Arabian Shield Development Company (the "Company"), a Delaware corporation, was formed on May 4, 1967. Throughout its history, the Company has operated oil and gas properties in the United States, sold and exchanged its common stock, and borrowed funds and pledged its assets, all for the ultimate purpose of developing mineral leases in Saudi Arabia and developing mines in the United States.

The Company has concluded it is a development stage enterprise and has presented its financial statements to conform to the disclosure requirements of the statement entitled "Accounting and Reporting by Development Stage Enterprises" issued by the Financial Accounting Standards Board.

Mineral Exploration and Development Costs—A major component of the Company's activities relates to the acquisition, exploration, and development of mineral deposits. All direct costs (including lease and license acquisitions, rentals, travel, geophysical, equipment, maps, charts, etc., but excluding corporate overhead) incurred are classified as mineral exploration and development costs until such time as (1) the Company can commence successful exploitation of the related mineral deposits, at which time that project's costs will be transferred to the accounts of the related project and amortized or depleted or (2) the related project is abandoned, at which time the project's costs will be written off. At December 31, 1982, no project had reached the stage described in (1). See Notes 2 and 3.

Other Assets—Other assets include property and equipment net of accumulated depletion and depreciation. Developed oil and gas leaseholds and intangible development costs have been fully depleted at December 31, 1982.

Per Share Data—Losses per share have been computed on the basis of the weighted average number of shares of common stock outstanding during the year. The exercise of stock options would be antidilutive.

Foreign Currency—Cash and accrued liabilities in Saudi Arabia are translated at current rates. Other amounts are translated at historical exchange rates.

Interest in Al Masane Project—The Company accounts for its 50% interest in the Al Masane Project by the equity method. See Note 3.

2. Mineral Exploration and Development Costs

Mineral exploration and development costs comprise the following:

	1982	1981
Saudi Arabian projects—cost of licenses, rentals, travel, field office and camp, core drilling, etc. relating to Al Masane (see Note 3), Greater Al Masane, Wadi Qatan, Jebel Harr, and Jabal Guyan areas	$6,418,120	$6,102,463
United States mines—costs of options to acquire mining interests and/or stock—Pioche Mines Consolidated, Inc. and Ely Valley Mines, Inc. and subsequent costs of exercise of lease options and geophysical cost capitalized	282,574	235,202
Total	$6,700,694	$6,337,665

Saudi Arabia Projects—The Saudia Arabian Government awarded exploration licenses to the Company and National Mining Company ("NMC"), a Saudi Arabian company, for the Al Masane (see Note 3), Wadi Qatan, Jebel Harr, and Jabal Guyan areas. The exploration licenses by their terms have expired; however, the licenses have been orally extended for so long as mineral exploration is conducted. All license requirements have been complied with.

In 1978, the Company and NMC obtained authority to explore an area of 1,100 square kilometers surrounding Al Masane (Greater Al Masane). The Saudi Arabian Government has indicated that a license will be granted; however, 600 square kilometers of the license area must be relinquished one year after the license is formally granted.

If exploration licenses for Al Masane, Wadi Qatan, Jebel Harr, Jabal Guyan, and Greater Al Masane are converted to exploitation concessions, NMC will reimburse the Company for its share of costs (as defined in an agreement between the parties). The Company and NMC each hold a 50% interest in the exploration licenses. Exploratory work for Wadi Qatan, Jebel Harr, Jabal Guyan, and Greater Al Masane has been financed solely by the Company. Upon the conversion of Al Masane to an exploitation concession, Petromin (the official mining and petroleum company of the Saudi Arabian Government) has an option to acquire one-half of NMC's interest in Al Masane.

In December 1982, the Company entered into a joint venture with NMC, Red Sea Mining Company and Petromin for exploration of the Ghurayyah area which is believed to contain significant deposits of columbium and tantalum. The joint venture is attempting to obtain an exploration license from the Saudi Arabian Government. Petromin has a 55% interest and the remaining partners each have a 15% interest in the joint venture. Each partner will contribute his share of expenses. At December 31, 1982, the joint venture had incurred no costs at Ghurayyah.

Since cash in Saudi Arabia is restricted to the support and operations of the Saudi Arabian projects, such cash and accrued liabilities relating to the Saudi Arabian projects have been classified as noncurrent. Support of the Saudi Arabian projects is interpreted as including general and administrative expenses, some of which are incurred in the United States. Cash in Saudi Arabia at December 31, 1982 includes a time deposit of $1,661,835 bearing a variable interest rate (6% at December 31, 1982).

United States Mines—The Company holds options to acquire mining leases and/or stock in Pioche Mines Consolidated, Inc. ("Pioche") and Ely Valley Mines, Inc. ("Ely Valley") which expire in May 1984. The options provide for acquiring up to fifty-one percent of the stock of each company and the leases run for twenty-five years from the date of exercise. In 1972 the Company exercised its option on the lease with Ely Valley. The Company also owns stock in Pioche and Ely Valley. The Chairman of the Board of Directors of the Company also serves on the Board of Directors and is President of both Pioche and Ely Valley.

General—There can be no assurance that the Company will successfully develop any of these properties or, if developed, whether the mineral exploration and development costs will ultimately be realized. The realization of such costs is dependent upon a number of future events, some of which are beyond the control of the Company. Management of the Company believes each project merits additional expenditures and none of the costs at December 31, 1982 should be written off.

3. Interest in Al Masane Project

All costs incurred prior to 1979 were expended by the Company and are included in Mineral Exploration and Development Costs (see Note 2). Advances from the Company totaling $4,875,547 from 1980 to 1982 have been classified as Venturer's Capital in the separate financial statements of the Al Masane Project which are included herewith.

Phase I of the Al Masane Project (sinking shaft, tunneling and drilling) was completed in April 1981. Phase I was financed primarily by an $11,000,000 interest free loan obtained jointly by the Company and NMC in January 1979 from the Saudi Arabian Government. Repayment of the loan is to begin in January 1984 and is to be paid in 10 equal annual installments. All of the Company's assets in Saudi Arabia and equipment purchased with a portion of the loan proceeds are pledged as collateral to the loan. The loan is recorded in the separate financial statements of the Al Masane Project included herewith.

In August 1982, a full bank feasibility study conducted by Watts, Griffis and McOuat Limited and SNC Corporation was completed. The study concluded that the Al Masane Project would support commercial production for approximately nine years. Management of the Company believes that exploration conducted subsequent to the completion of the feasibility study supports commercial production for an additional six years. On the basis of the feasibility study and subsequent exploration, the Company and NMC are jointly attempting to obtain a $105,000,000 interest-free loan from the Saudi Arabian Government. The proceeds of the loan would be used to construct a 1,500 ton per day mining and milling complex.

4. Common Stock and Stock Options

Common Stock—The proceeds from common stock sales are used to conduct mineral exploration and development activities in Saudi Arabia and to defray general and administrative expenses in the United States. The agreements relating to stock sold to foreign investors provide that shares may not be traded in the United States markets unless registered under the United States Securities Act of 1933 or unless they are sold pursuant to an available exemption from registration. Some agreements with foreign investors also contain the following provisions:

a) Proceeds from the sale of stock will be used for the support and operation of the Saudi Arabian projects (See Note 2); and
b) Shareholders have certain pre-emptive rights to acquire additional shares of common stock sold by the Company.

In December 1981, under a prior commitment, the Company sold 100,000 shares of common stock to Hatem ElKhalidi, President of the Company, at $2.00 per share (the market price of the common stock at the date of the commitment) for $20,000 cash and a $180,000 note receivable payable in annual installments of $20,000 plus interest at 6%.

Stock Options—At December 31, 1982, 70,000 shares of the Company's authorized but unissued common stock were reserved for stock options. Subsequently, options for 30,000 shares were exercised at $4.00 per share (the fair market value at date of grant) and the remaining options for 40,000 shares expired. As approved by the Board of Directors, the exercised options were for $.40 per share in cash with the balance due in nine equal annual installments plus interest at 6%.

5. Income Tax Loss Carryovers

The Company has incurred substantial tax losses in prior years (including expensing of intangible development costs). Loss carryovers in the amount of approximately $400,000, at December 31, 1982, are available for reduction of future taxable income in the United States. Such loss carryovers expire as follows: 1991, $70,000; 1992, $78,000; 1993, $73,000; 1994, $72,000; 1995, $53,000; and 1996, $20,000; and 1997, $34,000.

6. Commitments and Contingent Liabilities

In 1976 the Company assigned to a related party all the future net revenues of certain oil and gas properties in return for the cancellation of debt. The net revenues paid to the related party during 1982, 1981 and 1980 aggregated $36,000, $38,700, and $60,900, respectively.

The Company is jointly liable with NMC for the loan from the Saudi Arabian Government described in Note 3.

Auditors' Opinion

The Board of Directors and Stockholders,
Arabian Shield Development Company:

We have examined the balance sheets of Arabian Shield Development Company (a Company in the development stage) as of December 31, 1982 and 1981 and the related statements of operations, stockholders' equity, and changes in financial position for each of the three years in the period ended December 31, 1982 and cumulative from inception (May 4, 1967) to December 31, 1982. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As described in Note 2, a substantial portion of the total assets of the Company is represented by mineral exploration and development costs which have been deferred at December 31, 1982 and 1981. The exploration and development projects for mineral deposits were not being commercially operated as of December 31, 1982, and additional expenditures will be necessary before commercial operations, if any, are commenced. The ultimate recoverability of the mineral exploration and development costs cannot presently be determined.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the accompanying financial statements present fairly the financial position of the Company at December 31, 1982 and 1981 and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 1982 and cumulative from inception (May 4, 1967) to December 31, 1982, in conformity with generally accepted accounting principles applied on a consistent basis.

March 28, 1983

MAGMA POWER COMPANY

Consolidated Balance Sheet

Assets:	December 31, 1982	1981
Cash	$ 257	$ 190
Accounts receivable	130	121
Prepaid property taxes and other	117	125
Total current assets	505	436
Investments in joint ventures in the development stage (Note 3)	1,394	1,287
Land	858	858
Property, plant and equipment (Note 4):		
East Mesa machinery and equipment, at cost, net of accumulated depreciation of $548,679 in 1982 and $377,809 in 1981	3,803	3,612
Other property and equipment, net	325	350
Niland plant machinery and other costs, at cost	5,224	3,451
Intangible exploration and development costs, at cost, net of accumulated amortization of $614,087 in 1982 and $397,156 in 1981 (Note 5)	9,123	8,831
Magmamax Process patents at cost, net of accumulated amortization of $34,976 in 1982 and $30,395 in 1981	101	105
Other assets	182	111
	$21,519	$19,044

Liabilities:	1982	1981
Notes payable to directors (Note 6)	$11,038	$ 5,899
Accounts payable and accrued liabilities (Note 7)	1,254	832
Deferred cost reimbursement	250	—
Current portion of long-term debt (Note 8)	66	66
Total current liabilities	12,609	6,797
Long-term debt, net of current portion (Note 8)	433	500
Deferred compensation (Note 10)	248	219
Other long-term liabilities	491	435
	13,782	7,951
Commitments and contingencies (Note 14)		
Shareholders' Equity (Notes 1, 2 and 9):		
Common stock, $.10 par value, authorized 20,000,000 shares, issued and outstanding 9,987,577 shares	998	—
Additional paid-in capital	8,888	—
Retained earnings (deficit since June 11, 1982)	(2,150)	11,092
Total shareholders' equity	7,736	11,092
	$21,519	$19,044

The accompanying notes are an integral part of this statement.

Consolidated Statement of Operations

	Year Ended December 31, 1982	1981	1980
Revenues:			
Geothermal energy sales, including minimum support payments	$ 215	$ 317	$ 177
Insurance proceeds	108	—	—
Gain on sale of Geothermal Food Processors	—	212	—
Rental income	51	51	55
Other income	39	4	68
	415	585	301
Cost and expenses:			
Operator's costs at East Mesa (Note 4)	1,394	1,671	2,165
Depreciation and amortization	503	665	260
General and administrative	1,045	1,555	1,284
Abandoned leases and wells (Note 5)	64	123	—
Provision for investment in joint venture (Note 3)	230	461	—
Property taxes	157	189	136
Interest expense (Note 12)	375	—	—
	3,771	4,667	3,847
Net loss	($3,356)	($4,081)	($3,545)
Net loss per common share (Note 11)	($.34)	($.41)	($.36)

The accompanying notes are an integral part of this statement.

Consolidated Statement of Changes in Shareholders' Equity

	Common Stock (Note 2) Shares	Amount	Paid-In Capital (Note 2)	Retained Earnings (Deficit) (Note 2)	Total Shareholders' Equity (Note 2)
Balance, December 31, 1979	—	—	—	$ 5,008	$ 5,008
Issuance of common shares	—	—	—	6,573	6,573
Distributions from Geysers operations	—	—	—	4,172	4,172
Net loss, 1980	—	—	—	(3,545)	(3,545)
Balance, December 31, 1980	—	—	—	12,208	12,208
Distributions from Geysers operations	—	—	—	2,966	2,966
Net loss, 1981	—	—	—	(4,081)	(4,081)
Balance, December 31, 1981	—	—	—	11,092	11,092
Net loss, January 1, 1982 to June 11, 1982	—	—	—	(1,205)	(1,205)
Proceeds from exercise of rights issued former shareholders (Note 1)	9,987	$998	$28,963	—	29,962
Recapitalization due to reorganization June 11, 1982 (Note 1)	—	—	9,886	(9,886)	—
Use of proceeds to acquire non-Geysers net assets (Note 1)	—	—	(29,962)	—	(29,962)
Net loss, June 11, 1982 to December 31, 1982	—	—	—	(2,150)	(2,150)
Balance, December 31, 1982	9,987	$998	$ 8,888	($ 2,150)	$ 7,736

The accompanying notes are an integral part of this statement.

Consolidated Statement of Changes in Financial Position

	Year Ended December 31, 1982	1981	1980
Working capital was provided by:			
Proceeds from sale of Geothermal Food Processors (Note 3)	—	$ 675	—
Issuance of common shares (Note 1)	$29,962	—	$ 6,573
Long-term borrowings	—	495	—
Distributions from Geysers operations (Note 2)	—	2,966	4,172
Total working capital provided	29,962	4,136	10,745
Working capital was applied to:			
Operations:			
Net loss	3,356	4,081	3,545
Items not affecting working capital in the current period:			
Depreciation and amortization	(503)	(665)	(260)
Abandoned leases and wells	(64)	(123)	—
Abandoned machinery and equipment	(203)	—	—
Provision for investment in joint ventures	(230)	(461)	—
Gain on sale of Geothermal Food Processors	—	212	—
Other	(32)	(119)	2
Working capital applied to operations	2,322	2,923	3,287
Acquisition of non-Geysers net assets (Note 1)	29,962	—	—
Investments in joint ventures in the development stage	336	529	623
Additions to property, plant and equipment	2,425	2,119	1,504
Additions to intangible exploration and development costs	573	2,922	770
Transfer to intangible costs from joint ventures	—	(684)	—
Transfer from joint ventures to intangible costs	—	684	—
Reduction in long-term debt	66	—	2,401
Other, net	17	6	72
Total working capital applied	35,705	8,501	8,660
(Decrease) increase in working capital	(5,742)	(4,364)	2,085
Component changes in working capital:			
Cash	67	(288)	(430)
Account receivables	9	(12)	91
Prepaid property taxes and other	(7)	18	7
Notes payable to directors and short-term borrowings	(5,139)	(3,749)	1,650
Accounts payable and accrued liabilities	(421)	(267)	163
Deferred cost reimbursement	(250)	—	—
Current portion of long-term debt	—	(65)	603
(Decrease) increase in working capital	($ 5,742)	($4,364)	$ 2,085

The accompanying notes are an integral part of this statement.

Notes to Consolidated Financial Statements

1. Reorganization:

Magma Power Company (formerly Magma Development Corporation) is in the development stage and is involved in the exploration, development and sale of geothermal resources which are to be used primarily to generate electrical power. Magma Development Corporation (Magma Development) was incorporated in the State of Nevada on October 6, 1981. Since inception, and until June 11, 1982, Magma Development held no operating assets and was organized for the purpose of acquiring the assets and assuming the liabilities related thereto of Magma Power Company ('old' Magma, now Magma Geysers, Inc., an indirect wholly-owned subsidiary of Natomas Company (Natomas) except the assets and liabilities associated directly with 'old' Magma's interest in the Geysers Project in Lake and Sonoma Counties, California (hereafter referred to as the 'non-Geysers assets and liabilities').

Pursuant to the cash tender offer commenced by Natomas to acquire all the outstanding shares of 'old' Magma, a letter agreement was entered into on April 20, 1981, among Natomas, 'old' Magma, and certain individuals. In accordance with the letter agreement, Magma Development acquired and assumed all the non-Geysers assets and liabilities related thereto of 'old' Magma in exchange for all the proceeds received from the exercise of rights offered former shareholders of 'old' Magma whose shares were purchased pursuant to the cash tender offer and whose shares were surrendered pursuant to the merger of 'old' Magma into Natomas. The completion of the formal transfer of all non-Geysers assets and liabilities was completed June 11, 1982. Prior thereto, on April 23, 1982, Magma Development had changed its name to Magma Power Company.

2. Basis of Presentation and Principles of Consolidation:

The consolidated financial statements present the assets, liabilities, revenues, costs and expenses of Magma Power Company (the Company), and the accounts of the Company's 65%-owned subsidiary, Magma Energy, Inc. (Magma Energy) and 100%-owned subsidiaries, Imperial Magma and Magma Electric Company (Magma Electric). All intercompany transactions and accounts have been eliminated. Certain reclassifications have been made in 1981 in order to conform to 1982 classifications.

The assets and liabilities are presented in the accompanying financial statements on the same historical basis as they were carried on the records of 'old' Magma.

The consolidated balance sheet at December 31, 1981 and the consolidated statements of operations and changes in financial position for the years ended December 31, 1982, 1981, and 1980 present the financial position and results of operations as if the Company had owned the non-Geysers assets and liabilities at that date and during those periods, respectively. However, prior to June 11, 1982 (the date the Company acquired the non-Geysers assets and liabilities), net cash distributions from the Geysers Project provided funds used to finance 'old' Magma's development stage projects and ventures. Therefore, the financial statements do not purport to reflect the results of operations that would have resulted if 'old' Magma had been operated independently (without the Geysers operations) for the periods shown. In order to properly reflect the Company's equity and working capital position, contributions equal to the net cash distributions from the Geysers' project are included in the consolidated statements of changes in shareholders' equity and financial position for the years ended December 31, 1981 and 1980. Similarly, all other activity prior to June 11, 1982 has been classified under retained earnings (deficit) in the consolidated statement of changes in shareholders' equity.

The Company's other significant accounting policies are described in the following notes.

3. Investments in Joint Ventures in the Development Stage:

The Company and its subsidiaries are coventurers in several projects in the development stage for the purpose of drilling wells and developing production of geothermal energy. The Company's investment represents its share of drilling and lease acquisition and carrying costs, net of allowance for abandoned leases and wells. At such time as the joint ventures begin successful operations, the Company will include its share of joint venture operations in its accounts. The recoverability of the Company's investment in joint ventures depends upon the joint ventures commencing profitable operations which presently cannot be determined.

Imperial Magma—New Albion Resources Joint Venture (NARCO Joint Venture):

The Company has completed process engineering of a 28,500 kw net capacity geothermal power plant utilizing the geothermal energy produced from wells on land jointly held under lease by Imperial Magma and New Albion Resources Co. ("NARCO"), a wholly-owned subsidiary of San Diego Gas & Electric Co. ("SDG&E"). Initial generation from the project is expected in late 1984 or early 1985. In connection with the proposed plant, the Company entered into an agreement on February 21, 1980 to sell power produced from the plant to SDG&E at a fixed price subject to adjustments for inflation.

On May 5, 1981, Magma Power purchased for $100,000 cash and a $560,000 promissory note (see Note 8) all of NARCO's rights and interest in the geothermal energy to be produced from certain leaseholds in the Niland area of Imperial Valley, California, to supply the 28,500 kw net capacity plant.

Geothermal Food Processors, Inc.:

On May 13, 1981, Magma Energy sold to Geothermal Food Processors (Food Processors) for $675,000 all of its right title and interest in a 160 acre leasehold and wells thereon in the Brady, Nevada, area, along with its right to receive 15,000 shares of Food Processors. Magma Energy recognized a gain of approximately $213,000 on this transaction.

Other Joint Ventures:

The Company and its subsidiaries' other joint ventures are not under active development at this time. The Company continues to retain leaseholds and anticipates development in the future.

During 1982 and 1981, the Company determined certain joint venture leases and wells in Idaho and Imperial Valley, California, respectively, were not suitable for further use. Accordingly, a provision for investment in joint ventures representing intangible exploration and development costs previously capitalized of approximately $230,000 and $462,000 were charged to operations during the quarters ended December 31, 1982 and June 30, 1981, respectively.

4. Plant and Equipment:

Plant and Equipment in East Mesa:

During 1980, Magma Electric completed construction of a $15,000,000 pilot 11,000 kw geothermal power plant located in the East Mesa area of Imperial Valley, California. The pilot plant was built to demonstrate a practical method of generating electricity from low to medium temperature geothermal resources and to determine the technical and economic feasibility of the Magmamax Power Process.

Magma Electric has agreed to sell any electricity generated by the pilot plant to SDG&E at a price fixed for the first three years of operations (expiring October 1983), the price to be negotiated thereafter. The contract grants SDG&E a three-year option (expiring June 1983) to purchase the plant at the actual construction costs less approximately 5% per year.

Since the ability of Magma Electric to recover the cost of the pilot plant is uncertain, all construction costs were expensed as research and development, except for the cost of certain machinery and equipment which have alternative future uses in other research and development projects or otherwise, and the cost of the main building. Depreciation of the pilot plant and amortization of the related intangible exploration and development costs are computed on the straight-line method over 20 years commencing February 1980.

From January 1981 through the latter part of March of 1981, the plant was not operational due to repairs needed to the faulty turbine and heat exchanger. Operations were temporarily resumed during the latter part of March through September of 1981. Operations were again halted in October of 1981 pending the construction and installation of a new turbine, and heat exchanger and other equipment. Regular operations were resumed in November 1982 after the installation of a new turbine and heat exchanger and other equipment which are being leased by Magma Electric from B. C. McCabe, Chairman of the Board of Magma Power (Note 14).

Other Property and Equipment:

The balances of major classes of other machinery and equipment, at cost, at December 31, 1982 and 1981 are as follows:

	1982	1981
Building and leasehold improvements	$ 84,569	$ 42,362
Office equipment	115,476	114,034
Autos and trucks	127,916	129,502
Other equipment	329,090	321,366
Other	70,694	55,269
	727,745	662,533
Less, accumulated depreciation and amortization	402,370	311,553
	$325,375	$350,980

Depreciation on these assets is computed using the straight-line method with useful lives ranging from 3 to 10 years.

Niland Plant Machinery and Other Costs:

The Company has completed the process engineering associated with construction of a 28,500 kw net capacity geothermal power plant on land jointly leased by Imperial Magma and NARCO (See Note 3). The engineering in 1982 was performed by Dow Chemical, USA, Engineering and Construction Division, a wholly-owned subsidiary of Dow Chemical Co. (a significant shareholder of the Company). Fees paid to Dow USA amounted to approximately $1,500,000 in 1982.

5. Intangible Exploration and Development Costs:

Intangible exploration and development costs are expenditures for geothermal processing equipment patents, licenses and rights, and lease and well costs incurred by Magma Power and/or its subsidiaries. Such costs are capitalized and are amortized over the life of successful processes or estimated useful lives of the wells beginning at such time that the well is put into operation. The recovery of these costs depends principally upon future profitable geothermal operations, which presently cannot be determined. When a geothermal lease or project is abandoned, all related unamortized capitalized costs are charged to operations in the year of abandonment. During 1982 and 1981, the Company determined certain wells in Brady, Nevada and Imperial Valley, California and other locations were not suitable for further use. Accordingly, intangible exploration and development costs of approximately $64,000 and $124,000 were charged to operations in 1982 and 1981, respectively.

Patents granted are amortized over a 17-year period using the straight-line method.

6. Notes Payable to Directors:

Borrowings from certain directors consist of the following:

	December 31, 1982	1981
Interest bearing:		
B. C. McCabe	$ 9,891,678	$5,899,121
J. W. Aidlin	1,000,000	—
	10,891,678	5,899,121
Non-interest bearing:		
J. W. Aidlin	147,076	—
	$11,038,754	$5,899,121

The interest bearing notes have a stated interest rate of 11% per annum (8% from January 1, 1983) and are payable on demand. Proceeds of these borrowings were used for working capital purposes, as well as to finance certain capital expenditures. Total interest expense incurred on these notes for the years ended December 31, 1982 and 1981 amounted to approximately $900,000 and $357,000, respectively. The non-interest bearing amounts represent loans under an agreement whereby repayment is contingent upon the suitability of certain leaseholds for further development. No final determination at present has been made.

Although the notes to B. C. McCabe are demand notes, Mr. McCabe has stated that it is not his intention to call for payment of said notes or any substantial portion thereof during 1983, unless and until the Company is able to make such payment without interfering with its normal operations. Mr. McCabe has advised the directors of the Company that he has instructed the executors of his estate, by appropriate instrument, to carry out his said wish and commitment. Mr. McCabe has advised the directors of the Company that he will continue to provide capital in the form of further demand notes during 1983. As of March 22, 1983, additional borrowings from Mr. McCabe amounted to $1,260,000.

7. Accounts Payable and Accrued Liabilities:

Accounts payable and accrued liabilities consist of the following:

	December 31, 1982	1981
Accounts payable, trade	$1,094,976	$754,114
Accrued payroll and related taxes	74,412	59,425
Accrued interest	84,742	18,626
	$1,254,130	$832,165

8. Long-Term Debt:

Long-term debt consists of the following:

	December 31, 1982	1981
Note payable—NARCO (see Note 3)	$495,000	$560,000
Other	4,790	6,290
	499,790	566,290
Less: current portion	66,300	66,200
	$433,490	$500,090

The note payable to NARCO bears interest, payable monthly, at an annual rate of 18% or prime plus 1/2%, whichever is lower. Principal payments of $65,000 are payable annually commencing May 5, 1982, with the remaining balance of $365,000 payable on May 5, 1985. The note is secured by certain geothermal lease rights.

The Company has an unused line of credit of $10 million available from Natomas Co. pursuant to the letter agreement (Note 1). Borrowings under this line bear interest at prime plus one half percent. All outstanding amounts of principal and interest are payable quarterly and any unpaid balance is due and payable May 5, 1984. B. C. McCabe, Chairman of the Board, has guaranteed the payment of all sums due under the line. The agreement contains restrictive covenants which, among other things, requires the Company to obtain the consent of Natomas Co. before obtaining any secured borrowings and limits the Company's ability to pay dividends. No borrowings under this line have been made during 1982 and 1981.

9. Shareholders' Equity:

Common Stock:

Pursuant to the cash tender offer (Note 1), former stockholders were given rights to subscribe for 9,987,577 common shares of the Company. The subscription expired on June 9, 1982, and the Company issued 9,987,577 common shares par value $.10 pursuant to the subscription offer.

Stock Option Plans:

The following information relates to Magma Energy:

At December 31, 1982, 215,000 shares of common stock of Magma Energy are available for granting and are reserved for sale to certain directors, field and office personnel and others under a nonqualified stock option plan approved by the shareholders in 1970. The option price shall be fixed by the Board of Directors or, if not so fixed, shall not be less than $1.25 per share. Options are exercisable at date of grant and may not be exercised later than seven years from the date of grant. A promissory note totalling $25,500 which was received in consideration for options exercised, was deducted from shareholders' equity in 1981 and was paid in 1982. There were no options outstanding at December 31, 1982 and 1981 and no options were exercised during 1982, 1981 and 1980.

The following information relates to Imperial Magma:

At December 31, 1982, 105,000 shares of Imperial Magma's common stock are reserved under a nonqualified stock option plan for issuance to key officers and employees of the Company. The option price and terms shall be fixed by the Board of Directors. There were no options outstanding at December 31, 1982 and 1981, and no options were exercised during 1982, 1981 and 1980.

When options are exercised, the par value of shares purchased is credited to common stock and the excess credited to additional paid-in capital.

10. Employee Benefit Plans:

The Company and its subsidiaries have a profit-sharing employee stock ownership plan (Plan) covering substantially all employees. The Plan is noncontributory and employer contributions are funded as accrued by contributing common stock of Magma Energy. Contributions under the Plan are based upon a defined percentage of participant's salaries and are dependent on the profits of the Company. Under the Plan, the participant's interest is subject to specified vesting provisions. The liability of the Company is limited to the funds in the Profit-Sharing trust. The total cost of the Plan was approximately $13,000 in 1981, and $163,000 in 1980. There were no costs associated with this plan in 1982.

Effective January 1, 1982, the Company and its subsidiaries terminated its target benefit employee stock ownership plan which covered substantially all employees. Contributions under this plan were based upon an amount required to provide an annuity at retirement of 13% of the participant's highest average monthly compensation over a period of three consecutive years. The Company has no remaining liability with respect to this plan at December 31, 1982, and all amounts remaining in the target benefit trust will be distributed to the participants. The total cost of this plan for the years ended December 31, 1981 and 1980 was $50,000 and $23,000, respectively. There were no costs associated with this plan in 1982.

The Company and Magma Energy have unfunded deferred compensation arrangements with three key employees. The arrangements generally provide that the employee shall receive for life upon retirement a specified monthly amount less normal social security benefits and any other retirement benefits payable under the Plans described above. Estimated future benefits under these arrangements are being accrued over a twenty-year period. Amounts accrued for 1982, 1981, and 1980 were approximately $29,000, $39,000, and $9,000, respectively.

11. Net Loss Per Common Share:

Net loss per common share was computed using the weighted average number of common shares outstanding (9,987,577) during the period June 11, 1982 through December 31, 1982, as if this same amount was outstanding for the two years and period prior to June 11, 1982.

12. Capitalized Interest:

In accordance with Statement of Financial Accounting Standards No. 34, the Company capitalizes interest costs incurred in connection with the construction of certain assets. Interest costs incurred and capitalized for the year ended December 31, 1982 were $1,031,026 and $655,517, respectively. The entire interest cost incurred for the years ended December 31, 1981 and 1980 of approximately $598,000 and $473,000, respectively, was capitalized.

13. Income Taxes:

The Company and its wholly-owned subsidiaries have approximately $3,023,000 of operating loss carryforwards expiring in 1997 available to reduce the tax on future accounting income, if any. The operating loss carryforward for federal income tax purposes has not as yet been determined pending allocation of the purchase price of $29,962,732 to the Company's assets (Notes 1 and 2).

Investment tax credits are accounted for using the "flow-through" method.

14. Commitments and Contingencies:

Litigation:

Three class actions are pending against 'old' Magma, its directors, and others in connection with the tender for 'old' Magma shares and the related merger: Barch, etc. v. Magma Power Company, et. al., filed on May 5, 1981 in the United States District Court for the Central District of California, Plaine, etc. v. B. C. McCabe, et. al., filed on February 26, 1982 in the Superior Court of the State of California, County of Los Angeles, and Plaine, etc. v. B. C. McCabe, et. al., filed in the United States District Court for the Central District of California.

The Barch complaint alleges violations of the Securities Exchange Act of 1934 and seeks unspecified damages. The Plaine cases allege breaches of fiduciary duties by the defendants and violations of the Securities and Exchange Act of 1934 and seek unspecified damages. "Old" Magma and its directors have filed answers in all three actions denying all material allegations in the respective complaints.

Since 'new' Magma's management cannot determine, at this time, the ultimate outcome, nor what, if any, obligation may be incurred by the Company, no provision for any liability that may result has been reflected in the financial statements.

Leases:

The Company leases a turbine and heat exchanger along with certain other equipment in use at the East Mesa plant valued at approximately $5,500,000 under an operating lease from B. C. McCabe, chairman of the board of Magma Power. The lease commenced on April 20, 1982 and terminates on April 21, 1986.

Rent under the lease is based on a percentage of gross receipts from the sale of electrical power generated by the East Mesa Plant. The total of such contingent rentals charged to operations for the year ended December 31, [sic].

15. Development Stage Financial Data:

The following information summarizes the Company's financial activities since inception:

(a) Summary of Cumulative Loss from Inception (June 11, 1982) To December 31, 1982:

Revenues:	
Geothermal energy sales	$ 215,650
Rental and other income	81,934
	297,584
Costs and expenses:	
Operator's costs at East Mesa	1,014,934
Depreciation and amortization	276,175
General and administrative	557,390
Abandoned leases and wells	64,349
Provision for investment in joint venture	230,011
Property taxes	90,792
Interest expense	214,717
	2,448,368
Cumulative loss at December 31, 1982	($2,150,784)

(b) Summary of Changes in Financial Position from Inception (June 11, 1982) to December 31, 1982:

Working capital was provided by:	
Issuance of common shares	$29,962,732
Total working capital provided	29,962,732
Working capital was applied to:	
Operations:	
Net loss	2,150,784
Add (deduct) items not requiring use of working capital:	
Depreciation and amortization	(276,175)
Provision for investment in joint venture	(230,011)
Abandoned leases and wells	(64,349)
Loss on disposition of machinery and equipment	(203,767)
Other, net	(164,528)
Working capital applied to operations	1,211,954
Acquisition of non-Geysers net assets	29,962,732
Investments in joint ventures in the development stage	80,274
Additions to property, plant and equipment	1,438,696
Intangible exploration and development costs	225,086
Other, net	1,318
Total working capital applied	32,920,060
Decrease in working capital	($2,957,328)

(c) Condensed Summary of Shareholders' Equity from Inception (June 11, 1982) to December 31, 1982:

			Common Stock			
Year	Description	Amount per Share	Number of Shares	Amount	Additional Paid-In Capital	Total
1982	Initial issuance for cash	$3.00	9,987,577	$998,758	$28,963,974	$29,962,732
	Recapitalization due to reorganization				9,886,916	9,886,916
	Use of proceeds to acquire non-Geyser net assets				(29,962,732)	(29,962,732)
	Balance, December 31, 1982		9,987,577	$998,758	$ 8,888,158	$ 9,886,916

Auditors Report

The Board of Directors
Magma Power Company

We have examined the consolidated balance sheet of Magma Power Company and subsidiaries as of December 31, 1982 and 1981, and related consolidated statements of operations, shareholders' equity, and changes in financial position for the years ended December 31, 1982, 1981 and 1980. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Since its inception, the Company has been in the development stage with its primary activity exploration and development of geothermal resources. The Company does not as yet have significant revenues from the sale of geothermal energy. As discussed in Note 6 to the financial statements, the Company's capital is supplied directly by B. C. McCabe, chairman and principal shareholder of the Company in the form of demand notes. Mr. McCabe has advised the directors of the Company that he will continue to provide capital in the form of demand notes and will not call for payment of said notes or any substantial portion thereof during 1983, unless and until the Company is able to make such payment without interfering with its normal operations.

As discussed in Note 3, 4 and 5 to the financial statements, the ultimate recovery of the Company's capitalized costs of investments in the development stage, property, plant and equipment and intangible exploration and development costs is dependent upon future profitable operations which presently cannot be determined.

As discussed in Note 14 to the financial statements, the Company is financially responsible for defense and indemnity of its directors (who were formerly directors of Magma Geysers, Inc., formerly Magma Power Company), a wholly-owned indirect subsidiary of Natomas Company, in three class action suits in connection with the tender offer by Natomas Company for shares of Magma Power Company (now Magma-Geysers, Inc.) (Note 1). Since Management cannot determine, at this time, the ultimate outcome, nor what, if any, obligation may be incurred by the Company, no provision for any liability that may result has been reflected in the accompanying financial statements.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainties in the three preceding paragraphs been known, the financial statements referred to above present fairly the consolidated financial position of Magma Power Company and subsidiaries at December 31, 1982 and 1981 and the consolidated results of their operations and changes in financial position for the years ended December 31, 1982, 1981 and 1980, in conformity with generally accepted accounting principles applied on a consistent basis.

March 22, 1983

OPINION WITHOUT "SUBJECT TO" QUALIFICATION

MICRO Z CORP.

Statement of Stockholders' Equity (Deficiency in Assets)

(A Development Stage Company)

	Common Stock		Preferred Stock		Deficit Accumulated During Development Stage	Total
	Shares	Amount	Shares	Amount		
Balance—March 1, 1979 (Inception)	—	$ —	—	$ —	$ —	$ —
Issuance of Common Stock—April 15, 1979 (For cash; valued at $.0002895 per share)	345,380	100	—	—	—	100
Net (loss)	—	—	—	—	(589,839)	(589,839)
Balance—(Deficit) February 29, 1980	345,380	100	—	—	(589,839)	(589,739)
Conversion of Long-term Debt to Equity (Note 9)—As of August 31, 1980 (Valued at $10.00 per share)	—	—	66,000	660,000	—	660,000
Recapitalization (Note 9)—As of August 31, 1980 (Valued at $.001092 per share)	2,654,620	2,900	—	—	(2,900)	—
Net Income	—	—	—	—	236,585	236,585
Balance—(Deficit) February 28, 1981	3,000,000	$3,000	66,000	$660,000	$(356,154)	$306,846

See Notes to Financial Statements.

Balance Sheets

(A Development Stage Company)

Assets

	February 28, 1981	February 29, 1980
Current Assets		
Cash	$ 200,340	$ 483
Notes receivable—current portion (Notes 5 and 8)	174,995	63,503
Accounts receivable—trade, net of allowance of $40,293 in 1981	361,652	99,296
Loan receivable—officer	37,000	—
Inventories (Notes 2, 4, 6 and 8)	646,507	581,732
Prepaid expenses and other current assets	605,266	13,483
Total Current Assets	2,025,760	758,497
Property and Equipment—At Cost (Notes 2, 6 and 8)		
Equipment	56,707	319,339
Furniture and fixtures	36,199	36,199
Leasehold improvements	10,935	10,935
	103,841	366,473
Less accumulated depreciation and amortization	25,807	49,023
	78,034	317,450
Other Assets		
Notes receivable—less current portion (Notes 5 and 8)	556,685	254,011
Unamortized costs of purchased software (Note 2)	310,397	317,091
Other	35,500	24,831
	902,582	595,933
Total Assets	$3,006,376	$1,671,880

Liabilities and Stockholders' Equity (Deficiency in Assets)

	February 28, 1981	February 29, 1980
Current Liabilities		
Notes payable (Note 7)	$ 50,000	$ 100,000
Accounts payable and accrued expenses	768,668	546,726
Accrued costs on completed installations (Note 11)	—	60,760
Income taxes payable	40,100	—
Current portion of long-term debt (Note 8)	773,464	122,509
Other current liabilities	44,358	15,221
Total Current Liabilities	1,676,590	845,216
Long-term Debt, Net of Current Portion (Note 8)	1,022,940	1,416,403
Total Liabilities	2,699,530	2,261,619
Commitments and Contingencies (Note 14)	—	—
Stockholders' Equity (Deficiency in Assets)		
Preferred stock (Note 9)	660,000	—
Common stock (Note 9)	3,000	100
Deficit accumulated during the development stage	(356,154)	(589,839)
Total Stockholders' Equity (Deficiency in Assets)	306,846	(589,739)
Total Liabilities and Stockholders' Equity (Deficiency in Assets)	$3,006,376	$1,671,880

See Notes to Financial Statements.

Statements of Changes in Financial Position
(A Development Stage Company)

	Year Ended February 28, 1981	Year Ended February 29, 1980	Cumulative Amounts From Company's Inception
Source of Funds			
Earnings (loss) before extraordinary item	$ 144,285	$ (677,396)	$ (533,111)
Expenses not requiring outlay of working capital in current period			
Depreciation and amortization	26,267	62,690	88,957
Deferred income taxes	(14,900)	—	(14,900)
Funds provided from (used) by operations, exclusive of extraordinary items	155,652	(614,706)	(459,054)
Extraordinary items:			
Reduction of income taxes arising from carry-forward of prior years' operating losses	92,300	—	92,300
Increase in income due to early extinguishment of debt	—	87,557	87,557
Long-term debt borrowings	1,020,000	1,425,988	2,445,988
Increase in preferred stock resulting from conversion of long-term debt	660,000	—	660,000
Reduction of long-term notes receivable	182,570	—	182,570
Transfer of property and equipment to inventory	224,073	—	224,073
Issuance of common stock	—	100	100
	2,334,595	898,939	3,233,534
Application of Funds			
Additions to property and equipment	—	366,473	366,473
Purchase of software	—	325,778	325,778
Additions to long-term notes receivable	485,243	254,011	739,254
Reduction of long-term debt	1,413,463	9,585	1,423,048
Increase in other assets	—	29,811	29,811
	1,898,706	985,658	2,884,364
Increase (Decrease) in Working Capital	$ 435,889	$ (86,719)	$ 349,170
Increase (Decrease) in Working Capital			
Cash	$ 199,857	$ 483	$ 200,340
Notes receivable—current portion	111,492	63,503	174,995
Accounts receivable	262,356	99,296	361,652
Loan receivable—officer	37,000	—	37,000
Inventories	64,775	581,732	646,507
Prepaid expenses and other current assets	591,783	13,483	605,266
Notes payable	50,000	(100,000)	(50,000)
Accounts payable and accrued expenses	(221,942)	(546,726)	(768,668)
Accrued costs on completed installations	60,760	(60,760)	—
Income taxes payable	(40,100)	—	(40,100)
Current portion of long-term debt	(650,955)	(122,509)	(773,464)
Other current liabilities	(29,137)	(15,221)	(44,358)
Increase (Decrease) in Working Capital	$ 435,889	$ (86,719)	$ 349,170

See Notes to Financial Statements.

Statements of Operations
(A Development Stage Company)

	Year Ended February 28, 1981	Year Ended February 29, 1980	Cumulative Amounts From Company's Inception
Net Sales	$1,030,063	$1,058,723	$2,088,786
Other Income (Note 11)	1,552,325	516,460	2,068,785
Interest Income	65,152	—	65,152
	2,647,540	1,575,183	4,222,723
Costs and Expenses			
Cost of sales	579,424	728,731	1,308,155
Selling, general, and administrative expenses	1,428,367	1,255,580	2,683,947
Research and development costs	217,480	202,654	420,134
Interest expense	160,484	65,614	226,098
	2,385,755	2,252,579	4,638,334
Earnings (loss) Before Income Taxes and Extraordinary Item	261,785	(677,396)	(415,611)
Provision for Income Taxes (Note 12)	117,500	—	117,500
Earnings (loss) Before Extraordinary Item	144,285	(677,396)	(533,111)
Extraordinary Item (Note 13)	92,300	87,557	179,857
Net Earnings (loss)	$ 236,585	$ (589,839)	$ (353,254)
Earnings (loss) per Common Share, Restated to Reflect Recapitalization (Notes 9 and 10):			
Before extraordinary item	$.0393	$(.2258)	
Extraordinary item	.0308	.0292	
Net Earnings (loss) per Common Share	$.0701	$(.1966)	
Number of Shares Used in Computation (Note 10)	3,000,000	3,000,000	

See Notes to Financial Statements.

Notes to Financial Statements
(A Development Stage Company)

For the Years Ended February 28, 1981 and February 29, 1980

Note 1—Organization and Business Activity

Organization

The Company was incorporated under the laws of California on February 28, 1979 and commenced operations on March 1, 1979 as a development stage company. The Company changed its name from ODP Systems, Inc. to Micro-Z Corp. on May 27, 1980.

Development Stage Enterprise

The Company is a development stage enterprise primarily engaged in the business of designing, producing, marketing, installing and servicing microprocessor based turnkey hotel systems.

Note 2—Summary of Significant Accounting Policies

Inventories

At February 28, 1981, the Company changed its method of accounting for inventory from lower of cost (average method) or market, to lower of cost (first-in, first-out method) or market on all purchases subsequent to February 29, 1980 (Note 4).

Depreciation and Amortization

Property and Equipment are depreciated on a straight-line basis over the estimated useful lives of the assets as follows:

Equipment	10 years
Furniture and fixtures	10 years
Leasehold improvements	Life of lease

Depreciation and amortization expense for the years ended February 28, 1981 and February 29, 1980 is $14,593 and $49,023, respectively.

Expenditures for maintenance and repairs are charged directly to the appropriate operating account at the time the expense is incurred. Expenditures determined to represent additions and betterments are capitalized.

Intangible Assets

Purchased software is being amortized over estimated sales of 150 units, not to exceed three years. Expiration of the three-year period is February 28, 1982.

The Company has elected to amortize organization costs on a straight-line basis over a five-year period.

Amortization expense for purchased software for the years ended February 28, 1981 and February 29, 1980 is $6,694 and $8,687, respectively. Amortization of organization costs for the years ended February 28, 1981 and February 29, 1980 is $4,980 and $4,980, respectively.

Accounting for Research and Development Programs

The Company is engaged in performing work on research and development programs through joint ventures. Earnings from these programs are reported on the percentage-of-completion method. Losses are recorded when incurred.

Income Taxes

Investment tax credits are recorded under the flow-through method of accounting as a reduction of the provision for federal income taxes when the credits are realized.

Note 3—Major Customer/Supplier

Transactions with three customers accounted for approximately $860,000 and $655,000 in sales in 1981 and 1980, respectively. Outstanding notes and accounts receivable from those customers were $467,000 and $30,000 at February 28, 1981 and February 29, 1980, respectively. Additionally, the Company sold three research and development programs for $1,400,000 (Note 11).

Transactions with one supplier accounted for approximately $245,000 and $1,000,000 in inventory purchases in 1981 and 1980, respectively. Outstanding accounts and notes payable to this supplier were $1,408,000 and $1,451,000 at February 28, 1981 and February 29, 1980, respectively.

Note 4—Change in Accounting Principle

Effective with the year ended February 28, 1981, the Company changed its method of accounting for inventory from lower of cost (average method) or market, to lower of cost (first-in, first-out method) or market, on all purchases subsequent to February 29, 1980. The new method will achieve a more consistent and systematic determination of inventory and cost of sales. This change in accounting principle had an immaterial effect on net income for the year ended February 28, 1981. The pro forma and cumulative effects on net income of prior years are not determinable because the necessary information is unavailable.

Note 5—Notes Receivable

During the year ended February 29, 1980, the Company assumed notes receivable and notes payable (Note 8) from a third party. Additionally, sales were made during both years in exchange for notes. The balance at February 28, 1981 and February 29, 1980 is as follows:

	February 28, 1981	February 29, 1980
15½%-32% notes from a major customer, collateralized by equipment, payable in monthly installments of $9,440 at February 28, 1981 and $8,219 at February 29, 1980, including interest. The notes are shown net of interest and mature February 1985	$315,782	$317,514
10% note from a major customer, collateralized by equipment, payable in monthly installments of $8,879, including interest, for 60 months. A final payment is due after 60 months of $44,800. The note is shown net of interest and matures September 1985	415,898	—
	731,680	317,514
Less current portion	174,995	63,503
	$556,685	$254,011

Note 6—Reclassification of Property and Equipment to Inventory

During fiscal year ended February 29, 1980, the Company used certain items of computer hardware, the same type which are sold by the Company to their customers, for their own research and development testing and general office use. At February 29, 1980, this computer hardware was classified as property and equipment and depreciated over a five-year life.

As a result of the Company making this computer hardware available to their customers in the normal course of business, the Company reclassified these items to inventory during fiscal year ended February 28, 1981.

For the nine months ended November 30, 1980, the Company expensed $59,000 representing depreciation of computer hardware considered property and equipment. At February 28, 1981, depreciation expense was reduced by $59,000 due to reclassification of computer hardware to inventory.

Note 7—Notes Payable

At February 29, 1980, the Company owed a bank $100,000 at prime plus 2%. The note was secured by the personal guarantee of one shareholder. The debt matured on March 28, 1980 and was paid by the Company.

Note 8—Long-Term Debt

At February 28, 1981 and February 29, 1980, long-term debt consisted of the following:

	February 28, 1981	February 29, 1980
2% over prime (prime rate at February 28, 1981 and February 29, 1980 was 19% and 16¾%, respectively), loan payable to bank—secured by notes receivable (Note 5). Payable in monthly installments of $4,793 plus interest. Debt matures November 1984	$ 220,525	$ 278,033
6% note payable—secured by certain fixed assets and inventory with interest payable quarterly. Principal due March 2, 1982. Subsequent to February 29, 1980 interest was waived by the creditor for the period May 1, 1980 through December 31, 1980	849,924	849,924
6% note payable—secured by inventory, due 1981-1982 (A)	365,955	410,955
Notes payable at prime, due 1982 (B)	10,000	—
Notes payable at prime plus 2% due 1982 (C)	350,000	—
	1,796,404	1,538,912
Less current portion	773,464	122,509
	$1,022,940	$1,416,403

(A) On December 7, 1979 the Company entered into an agreement to finance inventory purchased. The entire principal balance at February 29, 1980 is due within one year. Interest is payable at 6% commencing March 1980 and monthly thereafter. Subsequent to February 29, 1980 the Company refinanced its short-term obligation with long-term debt. The terms include monthly installments, at various amounts, maturing February 1982. Interest at 6% was waived by the creditor from May 1, 1980 through December 31, 1980.

At February 28, 1981, the Company had not paid $20,000 due December 1980. In March 1981 the Company paid the $20,000 past due and is now current on its installments due.

(B) During May 1980, the Company borrowed $670,000 from a general partnership. At February 28, 1981, the general partnership owns 48¾% of the Common Stock and all of the Series A Preferred Stock of the Company. One of the general partners is a corporation, the president of which is also a current director of Micro Z Corp. Additionally, the stockholders of that corporation are trusts for the benefit of the president and members of his family. Another of the general partners is a limited partnership, the limited partners of which include members of the aforementioned director's family. The loan is secured by all of the assets of the Company and an insurance policy on the life of a stockholder. Accrued interest on the loan is payable May 1981, and principal plus accrued interest is payable in full May 1982. As of August 31, 1980, $660,000 of the loan was converted to preferred stock (Note 9). So long as the balance of the loan of $10,000 remains unpaid, the Company may not, among other things, repurchase any of its capital stock, incur certain debts, or merge or consolidate with another entity.

(C) During October 1980, the Company borrowed $350,000 from a limited partnership. An individual (one of the Company's current directors) is the trustee of a trust which is a limited partner of the partnership. The beneficiaries of such trust are members of the family of a current director who is also an officer of the Representative of the Underwriters of the Company's first public offering (Note 15). The loan is secured by all of the assets of the Company and an insurance policy on the life of a shareholder. Accrued interest on the loan is payable on October 3, 1981, and principal plus accrued interest is payable in full on October 3, 1982. So long as the loan remains unpaid, the Company may not, among other things, incur certain debts, merge or consolidate with another entity or issue any securities.

The limited partnership purchased from two shareholders of the Company an aggregate of 75,000 shares of Common Stock for nominal consideration. The partnership has been granted a right of first refusal to place 100 additional Units comprised substantially of the same securities as the Units being offered to the public (Note 15). This right of first refusal is for a period of three years commencing upon the completion of the first public offering. Further, an unaffiliated corporation, which participated in arranging the limited partnership loan transaction, was granted a similar right of first refusal to place 400 additional Units.

The Company has indicated in its prospectus filed with the Securities and Exchange Commission that this debt will be prepaid upon receiving the proceeds from its first public offering as required by the terms of the loan. In March 1981, the Company paid all monies due the limited partnership with the proceeds of its public offering.

Note 9—Change in Capital Structure

As of August 31, 1980, a recapitalization was completed with consent of the Company's shareholders.

The amended Articles of Incorporation include an increase in the aggregate number of authorized shares of common stock, the authorization of shares of preferred stock and a change from no par value to $.001 par value common stock. The amended Articles also provide for the exchange of no par value common stock for new shares of $.001 par value common stock.

As of August 31, 1980, the Company converted long-term debt of $660,000 into 66,000 shares of Series A Preferred Stock. A summary of capital stock at February 28, 1981 and February 29, 1980 is as follows:

	February 28, 1981	February 29, 1980
Preferred Stock:		
Authorized 10,000,000 shares $10 par value. 8% cumulative convertible Series A 66,000 shares issued and outstanding	$660,000	$—
Common Stock:		
Authorized 50,000,000 shares $.001 par value. 3,000,000 shares issued and outstanding	3,000	—
Authorized 1,000,000 shares no par value. 345,380 shares issued and outstanding	—	100
	$663,000	$100

Series A Preferred Stock may be redeemed out of earnings of the Company prior to March 1, 1982 or be redeemed subsequent to that date out of any available funds at 110% of the par value declining over a period of five years to par. This stock is convertible into Common Stock at the rate of five shares of Common for each share of Series A Preferred Stock converted. Holders of Series A Preferred Stock are entitled to receive an annual cumulative dividend of 8%.

A non-qualified stock option plan granting certain employees of the Company stock options for the purchase of common stock of the Company and related stock appreciation rights has been approved by the Board of Directors. A total of 750,000 shares limited to 3% of the issued and outstanding shares of common stock $.001 par value from the previously authorized but unissued common stock has been reserved for such sale. As of the date of the report, no stock options or stock appreciation rights have been granted under the plan.

Note 10—Earnings Per Share

Earnings per common share are computed on the basis of the average number of common shares outstanding, adjusted retroactively for stock splits in 1980. Converitible preferred stock has an antidilutive effect and has not been reflected in the computations of earnings per share.

Note 11—Other Income

Other income consists of:

	Year Ended February 28, 1981	Year Ended February 29, 1980
Income from assumption of uncompleted installations (A)	$ —	$344,000
Maintenance and rental income (B)	135,672	88,816
Miscellaneous	16,653	83,644
Research and development programs (C)	1,400,000	—
	$1,552,325	$516,460

(A) On February 28, 1979 the Company entered into an agreement to purchase certain assets of a business. In connection with that purchase, the Company agreed to complete certain installations for a fee of $344,000. All costs incurred to complete the installations are included in general and administrative expenses for the year. At February 29, 1980 substantially all installations were completed. Additional costs of $60,760 to complete the balance of the installations have been accrued by the Company.

(B) The Company's maintenance and rental income includes a long-term maintenance contract with a major customer (Note 14). Expenses incurred relating to such income are included in general and administrative expenses.

(C) The Company has entered into three joint venture agreements with three limited partnerships (Note 2). In the first joint venture agreement, the investors will pay to the Company the sum of $500,000 as the total cost of development of a software package program which will be a totally integrated software-hardware system for a hotel company which operates a gaming casino. The agreement provides that the investors will receive royalties from sales of the system.

In the second joint venture agreement, the investors will pay to the Company the sum of $750,000 as the total cost of development of a software package program which will be integrated with the telephone least-cost routing system to provide detailed billing for local and long distance calls for hotel guests. Upon completion, the agreement provides that the investors will receive royalties from sales of the product for a period of twelve years.

The third joint venture agreement stipulates that the investors will pay the Company the sum of $150,000 as the total cost of development of a software package program which will provide the accounting for advanced registration deposits to allow management to evaluate and control future reservations through cash deposits and to account for such deposits in order to provide fiscal security and control. Upon completion, the agreement provides that the investors will receive royalties from sales of the product for a period twelve years.

In the second joint venture, two limited partners were also directors of the Company. A consultant to the Company was the sole general partner of the second and third joint venture.

Note 12—Federal and State Income Taxes

No provision for income taxes has been made at February 29, 1980 as the Company has a net operating loss for its initial year of operations. At February 28, 1981, a net operating loss of $40,000 is available to be carried forward for federal income tax purposes.

At February 28, 1981, provision is made in the accounts to reflect the interperiod allocation of income taxes. This interperiod allocation arises primarily from treating research and development costs differently for financial reporting purposes than for tax computation purposes.

The provision for income taxes includes the following:

	Year Ended February 28, 1981	Year Ended February 29, 1980
Current taxes:		
Federal	$ —	$ —
State	40,100	—
	40,100	—
Deferred taxes:		
Federal	—	—
State	(14,900)	—
	(14,900)	—
Tax effect of loss carryforward:		
Federal	92,300	—
State	—	—
	92,300	—
Provision for income taxes	$117,500	$ —

Note 13—Extraordinary Item

At February 28, 1981, the extraordinary item represents the income tax benefit from the utilization of a prior year's operating loss.

During the year ended February 29, 1980, the Company renegotiated its notes receivable with a major customer. As a result of the renegotiation, the Company reported a gain of $87,557 representing an early extinguishment of debt and is shown as an extraordinary item. There are no income taxes provided as the Company has a net loss in its first year of operation.

Note 14—Commitments and Contingencies

Litigation

On October 3, 1980, suit was filed against Caesar's World, Inc., Online Distributed Processing Corporation, and Micro Z Corp., in United States District Court of California by Vollan Enterprises, Ltd., on the grounds of breach of contract, breach of expressed and implied warranties, and negligent misrepresentation relating to two systems designed and installed by Online Distributed Processing Corporation substantially prior to the formation of the Company.

While the Company strongly believes that any liability would be that of Online Distributed Processing Corporation or Caesar's World, Inc., the ultimate outcome of the lawsuit or the time required to defend it cannot be predicted. The Company is contesting the case vigorously.

Lease Agreements

Total rental expense at February 28, 1981 is $89,600. The Company has entered into operating lease agreements for rental of office facilities and equipment. Future minimum lease payments on noncancellable lease terms in excess of one year are as follows:

Years Ending	
February 28, 1982	$24,000
February 28, 1983	13,000
February 29, 1984	11,000
February 28, 1985	4,000
	$52,000

Maintenance Agreement

The Company services certain equipment it sells and has entered into several maintenance agreements, one of which is for a term of greater than one year. The terms of that contract are for five years beginning March 1, 1980 calling for monthly payments to the Company of $5,000. The monthly payments increase as the customer acquires more equipment.

Employment Agreements

On September 30, 1980, the President of the Company and the Company entered into a five-year Employment Agreement at an annual salary of $100,000 with cost-of-living increases.

On March 1, 1981, a Vice President of the Company and the Company entered into a three-year Employment Agreement at an annual salary of $50,000. The agreement includes an incentive program to be based on the Company's sales for each of the next three years.

Note 15—Subsequent Events

Sale of Capital Stock

On March 5, 1981, the Company completed its first public offering of securities by selling 5,000 Units at $1,000 per Unit. Each Unit consisted of 50 shares of 8% Noncumulative Convertible Series B Preferred Stock, $10 Par Value, 250 Shares of Common Stock, $.001 Par Value, and Warrants to Purchase 250 Shares of Common Stock.

Each holder of 8% Noncumulative Convertible Series B Preferred Stock will be entitled to receive, commencing March 1, 1981, noncumulative dividends at the rate of 8% per annum and may, at his option, convert each share of Series B Preferred Stock into five shares of Common Stock, the conversion rate being subject to adjustment in certain events. Commencing in 1981, the Series B Preferred Stock will be subject to redemption at the option of the Company upon at least 30 days prior notice. The redemption price will initially be 110% of par value, and will decline over a period of five years to par value. The Warrants entitle the holders thereof to purchase Common Stock at an initial exercise price of $2.00 per share, subject to adjustment in certain events. The Warrants, which will be attached to the Common Stock, will become detachable on June 4, 1981, unless earlier detachment is permitted by the Representative of the Underwriters. The Warrants will only be exercisable during the 30-day period April 5, 1982 to May 4, 1982.

Additionally, the Representative of the Underwriters was issued Warrants at $.10 per Warrant to purchase 457 Units comprised of the same securities as those contained in the Units sold to the public. The Underwriter's Warrants will be exercisable during the four-year period March 5, 1982 to March 4, 1986.

The proceeds from the public offering were as follows:

Sale of 5,000 Units	$5,000,000
Less: Underwriting discounts and commissions	(500,000)
Nonaccountable expenses to the Representative of the Underwriters	(150,000)
Other costs (included in other current assets)	(400,000)
	$3,950,000

Although the public offering was completed March 5, 1981, the following data is presented to show the stockholders' equity section of the balance sheet on a pro forma basis as if the sale were completed February 28, 1981.

	Pro Forma February 28, 1981
Preferred Stock:	
Authorized 10,000,000 shares, $10 par value;	
8% Cumulative Convertible—Series A, 66,000 shares issued and outstanding	$ 660,000
8% Noncumulative Convertible—Series B, 250,000 shares issued and outstanding	2,500,000
Common Stock:	
Authorized 50,000,000 shares $.001 par value; 4,250,000 shares issued and outstanding	4,250
Additional paid-in capital	1,448,750
Deficit accumulated during development stage	(356,154)
	$4,256,846
Earnings per common share:	
Before extraordinary item	$.0392
Extraordinary item	.0307
Earnings per common share	$.0699

Investment in Joint Ventures

At February 28, 1981, the Company advanced $165,000 to a non-affiliate to be applied toward the purchase of ten production units and a fifty percent interest in proprietary rights in certain software systems. The total cost of the purchase is $565,000.

Upon receiving the proprietary rights in the software systems, the Company and the corporation, from whom the rights were purchased, formed a new corporation whereby each party contributed their fifty percent interest in the rights and $25,000 in exchange for the stock of the new corporation. In addition to receiving fifty percent of the outstanding stock in the newly-formed corporation. Micro Z Corp. is to receive five production units. The new corporation will develop, manufacture and sell microprocessor based products and certain telecommunication systems.

In addition, Micro Z Corp. is presently negotiating an agreement with a company, whereby the two companies will each invest the sum of $250,000 to purchase one half of the stock in a proposed new company. The proposed company will provide hotels with the means to offer long distance telephone service to their guests.

Auditor's Opinion

Board of Directors
Micro Z Corp. (Formerly ODP Systems, Inc.)
Los Angeles, California

Members of the Board:

We have examined the balance sheets of Micro Z Corp. (formerly ODP Systems, Inc.), a development stage company (Note 1), as of February 28, 1981 and February 29, 1980, and the related statements of operations, stockholders' equity (deficiency in assets) and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Micro Z Corp. (formerly ODP Systems, Inc.) at February 28, 1981 and February 29, 1980 and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

May 6, 1981

BSD MEDICAL CORPORATION

Statements of Stockholders' Equity (Deficit)

(Development Stage Company)

Eight Months ended August 31, 1980, and Years Ended August 31, 1981 and 1982

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Total Stockholders' Equity (Deficit)
Balance at December 31, 1979 (resulting from issuance of shares at inception, cash contributions from major stockholder and cumulative losses)	800	$ —	999	(1,761)	(761)
Stock bonus to employees (note 6)	172	—	25	—	25
Net loss	—	—	—	(799)	(799)
Balance at August 31, 1980	972	—	1,025	(2,561)	(1,535)
Sale of common stock (note 6)	615	—	3,689	—	3,690
Costs associated with sale of common stock	—	—	(583)	—	(583)
Sale of stock warrants (note 6)	—	—	—	—	—
Shares issued in connection with conversion of $1,243,757 note payable to majority stockholder (note 6)	428	—	1,243	—	1,243
Net loss	—	—	—	(1,119)	(1,119)
Balance at August 31, 1981	2,015	1	5,375	(3,680)	1,695
Net loss	—	—	—	(1,155)	(1,155)
Balance at August 31, 1982	2,015	$1	5,375	(4,836)	540

See accompanying notes to financial statements.

Balance Sheets

(Development Stage Company)

	August 31, 1981	August 31, 1982
Assets		
Current Assets:		
Cash, including interest bearing time deposits in 1981 of $1,207,000	$1,250	397
Receivables (notes 4 and 5):		
Trade accounts	24	666
Current portion of note receivable	4	8
Net investment in sales-type lease (note 2)	—	16
Other, including accrued interest on time deposits in 1981 of $127,383	129	4
Total receivables	157	694
Inventories (notes 4 and 5):		
Raw materials	282	231
Work in process	54	120
Finished goods	62	96
Total inventories	399	448
Prepaid expenses (note 3)	46	66
Total current assets	1,854	1,606
Property and equipment, at cost (notes 2, 4 and 5):		
Leasehold improvements	42	48
Furniture and fixtures	95	95
Equipment	165	217
	302	361
Less accumulated depreciation and amortization	83	123
Net property and equipment	218	238
Long-term portion of note receivable	17	13
Net investment in sales-type lease (note 2)	—	84
Other assets, at cost less applicable amortization	19	53
	$2,110	1,996
Liabilities and Stockholders' Equity		
Current Liabilities:		
Notes payable (note 4)	$ 111	203
Current portion of long-term debt (note 5)	—	60
Current portion of obligations under capital leases (note 2)	3	26
Accounts payable	182	406
Accrued salaries and commissions	38	118
Other current liabilities	70	105
Total current liabilities	407	920
Obligations under capital leases, excluding current portion (note 2)	7	142
Long-term debt, excluding current instalments (note 5)	—	392
Stockholders' equity (deficit) (note 6):		
Common stock of $.0005 par value; authorized 6,000,000 shares; issued 2,015,000 shares	1	1
Additional paid-in capital	5,375	5,375
Deficit accumulated during the development stage	(3,680)	(4,836)
Total stockholders' equity	1,695	540
Commitments and contingencies (notes 2, 3, 8 and 11)		
	$2,110	1,996

See accompanying notes to financial statements.

Statements of Changes in Financial Position
(Development Stage Company)

	Eight Months Ended August 31, 1980	Year Ended August 31, 1981	Year Ended August 31, 1982	Cumulative Amounts from Inception (March 17, 1978)
Uses of working capital:				
Net loss	$ 799	1,119	1,155	4,836
Less items not using working capital:				
Depreciation and amortization	20	32	40	124
Shares of common stock issued to employees	25	—	—	25
Working capital used by operations	753	1,086	1,114	4,686
Additions to property and equipment	—	94	59	363
Increase in net investment in sales-type lease	—	—	84	84
Increase in other assets	—	19	34	94
Retirement of obligations under capital leases	2	4	32	39
Reduction of long-term debt	—	—	143	143
Reduction of note payable to majority stockholder	—	1,743	—	1,768
Increase in long-term portion of note receivable	—	17	—	17
Increase in working capital	—	1,383	—	686
	$ 756	4,350	1,468	7,884
Sources of working capital:				
Retirement of equipment	$ —	—	—	1
Obligations under capital leases	—	—	167	182
Proceeds from long-term debt	—	—	535	535
Proceeds from borrowings from majority stockholder	640	—	—	1,768
Net proceeds from sale of common stock and warrants	—	3,106	—	3,106
Additional cash contributions from majority stockholder	—	—	—	999
Decrease in long-term portion of note receivable	—	—	4	4
Decrease in other assets	40	—	—	40
Conversion of note payable to majority stockholder into common stock	—	1,243	—	1,243
Decrease in working capital	75	—	760	—
	$ 756	4,350	1,468	7,884
Changes in components of working capital:				
Increase (decrease) in current assets:				
Cash	$ (101)	1,237	(853)	397
Receivables	(60)	128	536	694
Inventories	70	62	48	448
Prepaid expenses	4	(5)	20	66
	(87)	1,423	(247)	1,606
Increase (decrease) in current liabilities:				
Notes payable	4	91	91	203
Accounts payable	(76)	(48)	223	406
Accrued salaries and commissions	51	38	80	213
Current portion of long-term debt	—	—	60	60
Current portion of obligations under capital leases	—	—	22	26
Other current liabilities	8	(41)	34	10
	(11)	39	513	920
Increase (decrease) in working capital	$ (75)	1,383	(760)	686

See accompanying notes to financial statements.

Statements of Operations
(Development Stage Company)

	Eight Months Ended August 31, 1980	Year Ended August 31, 1981	Year Ended August 31, 1982	Cumulative Amounts from Inception (March 17, 1978)
Revenues:				
Net sales	$119	819	1,818	3,061
Interest earned on time deposits	—	195	68	264
Other—net	13	1	18	33
	132	1,017	1,905	3,359
Expenses (note 9):				
Wages and consulting professional fees	541	1,182	1,549	4,470
Materials	71	437	929	1,878
Depreciation	20	32	40	123
Interest	97	8	68	220
Other operating expenses:				
Facility costs	77	131	143	473
Travel and conference costs	49	172	182	486
Insurance, office supplies, equipment rental and other	74	170	147	541
	200	475	472	1,501
	932	2,136	3,060	8,195
Net loss	$799	1,119	1,155	4,836
Loss per share of common stock based on weighted average number of shares outstanding	$(.82)	(.61)	(.57)	
Weighted average number of shares outstanding	972	1,825	2,015	

See accompanying notes to financial statements.

Notes to Financial Statements
(Development Stage Company)

(1) Summary of Significant Accounting Policies

(a) General

BSD Medical Corporation is considered a development stage company under Statement of Financial Accounting Standards No. 7. The Company was formed in 1978 for the purpose of conducting research and development into the uses of microwaves for the experimental treatment of cancer in animals and humans. It has developed an operating system called the BSD-1000 Hyperthermia System which utilizes microwaves for the selective heating of tissue.

The Company has received an Investigational Device Exemption from the United States Food and Drug Administration (FDA) which allows the Company to market the BSD-1000 system to qualified research institutions. The Company filed for Pre-Market Approval (PMA) with the FDA in 1982, which if obtained, will permit the sale and use of the BSD-1000 system for specified clinical therapy. Obtaining PMA is considered by the Company to be the key factor necessary to progress from a development stage company to an operating enterprise. Funding of present and future operations is largely dependent on anticipated increases in sales volume as a result of obtaining PMA. It may, however, be necessary for the Company to seek additional financing if PMA is not obtained in early 1983 as is presently anticipated.

(b) Inventories

Inventories are valued at the lower of cost (first-in, first-out) or market.

(c) Depreciation

Depreciation is provided for capitalized property and equipment. All such assets were acquired during the research and development phase and have alternative future uses. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets which range from 7 to 12 years.

(d) Federal Income Taxes

The Company was previously treated as a Subchapter S Corporation, whereby in lieu of corporate income taxes, the stockholders were either taxed on their proportionate share of the Company's income or utilized benefits resulting from losses. Accordingly, no effects for Federal income taxes were provided in the financial statements. As a result of the Company selling its stock to the public during 1980, the Company's Subchapter S election was terminated effective September 1, 1980. Accordingly, no benefits resulting from prior net operating losses are available to offset future taxable income. However, any losses incurred or tax credits obtained subsequent to August 31, 1980, will be available as carryforwards to offset future taxable income. The Company records investment tax credits as a reduction of the provision for Federal income taxes in the year realized (note 7).

(e) Loss per Share

Loss per common share has been computed by dividing net loss by the weighted average number of common shares outstanding. Common stock equivalents have not been included in the computation as their effect would be anti-dilutive.

(f) Reclassifications

Certain amounts previously reported in the 1980 and 1981 financial statements have been reclassified to conform to the 1982 presentation.

(2) Leases

Included in property and equipment are $29,709 and $22,300 related to equipment under capital leases at August 31, 1982 and 1981, respectively. Accumulated amortization on the property and equipment was $12,323 and $8,824 at August 31, 1982 and 1981, respectively.

The Company leases office space and equipment under cancellable and noncancellable operating type lease agreements. Rental expense for such leases was approximately $81,000, $81,000 and $51,000 for 1982, 1981 and 1980, respectively.

The Company's noncancellable long-term lease commitments are as follows:

	Type of Lease		
Year Ending August 31	Capitalized Leases	Operating Leases	Total Commitment
1983	$ 76,431	72,200	148,631
1984	72,242	69,900	142,142
1985	66,024	40,800	106,824
1986	66,024	—	66,024
1987	27,510	—	27,510
Total minimum lease payments	308,231	182,900	491,131
Imputed interest	138,965		
Present value of net minimum capital lease payments	$169,266		

It is generally expected that in the normal course of business, leases that expire will be renewed or replaced by other leases with similar terms.

The above capitalized lease commitment includes total payments of $291,606 relating to a sale-leaseback of a BSD-1000 system during 1982. Concurrent with the leaseback of the system the Company subleased it to a third party. In accordance with Statement of Financial Accounting Standards No. 13, as amended, the subleased equipment has been accounted for as a sales-type lease. Accordingly, property and equipment in the accompanying balance sheet excludes the capitalized value of the sub-leased equipment. The following lists the components of the net investment in the sales-type lease as of August 31, 1982:

Total minimum lease payments to be received	$147,519
Less: Unearned income	47,126
Net investment in sales-type lease	$100,393

(3) License Agreement

On July 1, 1979, the Company acquired an exclusive license to make, use or sell a device which measures the temperature in radio frequency heated material. In order to obtain the license, the Company agreed to pay an advance royalty of $25,000 each year for the next five years, or a greater amount based on annual units sold or used. The royalty of $25,000 is recorded in prepaid expenses net of accumulated amortization at August 31, 1981 and 1982. Royalties for the twelve months ended June 30, 1983, are not expected to exceed the prepaid amount. The royalty is being amortized over a period of one year.

(4) Notes Payable

Notes payable at August 31, 1981 and 1982, consisted of the following:

	1981	1982
Note payable to bank, secured by accounts receivable, inventory and equipment and guaranteed by both the Company's president and its major stockholder, due November 5, 1982, with interest at 17.5%	$ —	100,000
Unsecured note payable to major stockholder due on demand bearing interest at the prime rate (13.5% at August 31, 1982)	—	91,757
Unsecured note payable to major stockholder, noninterest bearing and due on demand (converted during 1982 to a long-term note payable—note 5)	94,737	—
Notes payable—other	16,519	11,305
	$111,256	203,062

(5) Long-Term Debt

Long-term debt at August 31, 1982, consisted of the following:

Notes payable to commercial bank, interest at 17.5% (renegotiated each six months), due in two semi-annual instalments of $58,500 plus interest, with a final payment of $233,000 due April 13, 1984; secured by accounts receivable, inventory and equipment and guaranteed by both the Company's president and its major stockholder	$350,000
Note payable to major stockholder; interest payable quarterly at the prime rate (13.5% at August 31, 1982) due December 31, 1983; unsecured (note 4)	94,737
13.8% note payable to finance company, payable in monthly instalments of $298, including interest, through September 1985; secured by equipment	8,946
Total long-term debt	453,683
Less current instalments	60,998
Long-term debt, excluding current instalments	$392,685

Maturities of long-term debt are as follows:

August 31,	
1983	$ 60,998
1984	389,103
1985	3,287
1986	295

(6) Common Stock

On January 2, 1980, the Company issued 172,000 shares of common stock to certain officers, directors, and employees as a bonus for services rendered. The stock was issued at the Company's estimated fair market value at that date, $.15 per share.

On September 18, 1980, the Company increased its authorized shares of common stock from 2,000,000 to 6,000,000 shares.

Effective December 9, 1980, the Company sold 615,000 shares of common stock to the public for $6 per share. The proceeds were used in part to retire $500,000 of a note payable due to the majority stockholder. The remaining balance of $1,243,757 due to the majority stockholder was converted on

September 18, 1980, to 428,000 shares of common stock. In addition, the Company sold to the underwriters, for an aggregate of $300, warrants to purchase 30,000 shares of the Company's common stock at $7.20 per share. The warrants will be exercisable for a period of five years beginning December 9, 1981.

As a condition of the registration of the common stock in the public offering, the majority stockholder and certain other stockholders who have served as directors and/or officers of the Company were required to place an aggregate of 949,591 shares of the Company's common stock owned by them in escrow. If the Company's earnings per share for the next five years (beginning in 1981) do not reach certain specified levels, all or a portion of the above shares must be returned to and cancelled by the Company, unless the terms of the escrow agreement are modified or extended.

(7) Federal Income Taxes

At August 31, 1982, the Company had net operating loss carryforwards for Federal income tax purposes of approximately $2,275,000. If not previously utilized, $1,120,000 will expire in 1996 and $1,155,000 in 1997. The Company also has investment tax credit carryforwards of $12,000 which will expire in 1996 and 1997 unless previously utilized.

(8) Employee Stock Option Plan

The Company's Board of Directors approved an employee incentive stock option plan on March 12, 1982, whereby certain key employees will be granted options to purchase shares of the common stock of the Company. The plan provides for the granting of options for an aggregate of 200,000 shares which are exercisable eighteen months after the date of grant. During 1982, options to purchase 94,000 shares at an exercise price of $4 per share were granted. No compensation expense was recognized since the fair market value of the stock did not exceed the option price at the date of grant.

(9) Research and Development

Research and development has been the principal function of the Company. Expenses in the accompanying financial statements include certain costs which are directly associated with the Company's research and development. These costs, which consist primarily of fees paid to individuals, materials and supplies amounted to approximately $480,000, $330,000 and $140,000 in 1982, 1981 and 1980, respectively.

(10) Sales to Foreign Customers

Revenues relating to foreign sales in 1982 and 1981 were approximately $645,000 and $269,000, respectively.

(11) Litigation

During 1981, the Company was involved in a patent lawsuit which was dismissed by the Court in favor of the Company during 1982. The Company is now involved in a related lawsuit as a result of the holder of the patent in the above case filing suit against the Company for patent infringement. The Company has counterclaimed for a declaration that the patent is invalid and not infringed. In the opinion of management, based on the advice of legal counsel, the patent appears invalid and the ultimate liability, if any, would not materially affect the Company's financial position.

Accountants' Report

The Board of Directors and Stockholders
BSD Medical Corporation:

We have examined the balance sheets of BSD Medical Corporation as of August 31, 1981 and 1982, and the related statements of operations, stockholders' equity (deficit) and changes in financial position for the eight months ended August 31, 1980, the years ended August 31, 1981 and 1982, and the cumulative amounts from inception (March 17, 1978). Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As more fully described in note 1 to the financial statements, BSD Medical Corporation is considered a development stage enterprise under Statement of Financial Accounting Standards No. 7.

In our opinion, the aforementioned financial statements present fairly the financial position of BSD Medical Corporation at August 31, 1981 and 1982, and the results of its operations and the changes in its financial position for the eight months ended August 31, 1980, the years ended August 31, 1981 and 1982, and the cumulative amounts from inception (March 17, 1978), in conformity with generally accepted accounting principles applied on a consistent basis.

 October 15, 1982

ROBOTIC VISION SYSTEMS, INC.

Consolidated Balance Sheets

(A Development Stage Company)

	September 30, 1982	1981
Assets		
Current assets:		
Cash (including certificates of deposit of $115,000 in 1982 and $200,000 in 1981)	$ 228	$ 251
Investment in short-term commercial paper (at cost, which approximates market)	450	370
Accounts receivable:		
United States Government (including unbilled receivables of $261,000 in 1982 and $161,000 in 1981)	610	403
Other (including unbilled receivables of $23,000 in 1982 and $7,000 in 1981) (less allowance for doubtful accounts of $2,000)	58	11
Inventories (at the lower of cost [first-in, first-out] or market), composed of raw materials of $4,000 and work in process of $252,000 in 1981 (Note D[5])		256
Accrued interest and other current assets	45	45
Total current assets	1,391	1,336
Factory, engineering and other equipment (at cost, less accumulated depreciation) (Note B)	371	353
Other assets	56	75
Total	$1,818	$1,764
Liabilities		
Current liabilities:		
Accounts payable and accrued expenses	$ 366	$ 88
Customer deposits	9	23
Accrued payroll and related employee benefits	173	137
Total current liabilities	548	248
Variable rate subordinated convertible notes due July 30, 1984 (Note C)	110	225
Deferred compensation (Note D[1])	153	120
Total liabilities	811	593
Commitments (Note D)		
Stockholders' Equity (Notes A, C and F)		
Capital stock—common—authorized 10,000,000 shares, $.01 par value; issued and outstanding 3,538,545 shares in 1982 and 3,419,557 shares in 1981	35	34
Additional paid-in capital	9,918	9,307
Less notes receivable (Note F[3])	(149)	(238)
	9,804	9,103
(Deficit) accumulated during the development stage	(8,797)	(7,932)
Total stockholders' equity	1,007	1,171
Total	$1,818	$1,764

The accompanying notes to consolidated financial statements are an integral part hereof.

Consolidated Statements of Changes in Stockholders' Equity Accounts
(A Development Stage Company)

	Common Shares Outstanding: Number of Shares	Common Shares Outstanding: Amount	Additional Paid-In Capital	Deficit
October 1, 1976 (inception) to September 30, 1977 (pro forma):				
Capital contributed by Dynell Electronics Corporation (Note A[1])	647	$ 6	$2,325	
Sale of stock to the Company's president (Note F[3] (a))	75	1	149	
Net (loss) for the period October 1, 1976 to September 30, 1977				$(1,233)
Balance—September 30, 1977	722	7	2,474	(1,233)
Capital contributed by Dynell Electronics Corporation from October 1, 1977 to December 27, 1977 (spin-off date) (Note A[1])			333	
Sale of stock in public offering	1,388	14	2,764	
Costs in connection with sale of stock in public offering			(69)	
Sale of stock to the Company's senior vice-president (Note F[3] (b))	25		89	
Cash disbursed and stock issued pursuant to the exercise of Dynell employee options (Note D[4])	10		(14)	
Net (loss) for the year ended September 30, 1978				(1,594)
Balance—September 30, 1978	2,147	21	5,577	(2,827)
Shares issued to retired employee	1		3	
Warrants issued in connection with subordinated convertible notes (Note C)			8	
Cash disbursed and stock issued pursuant to the exercise of Dynell employee options (Note D[4])	7		(20)	
Net (loss) for the year ended September 30, 1979				(1,825)
Balance—September 30, 1979	2,156	21	5,568	(4,652)
Shares issued on conversion of subordinated convertible notes (net of deferred borrowing costs) (Note C)	755	8	1,583	
Sale of stock pursuant to the exercise of employee incentive options (Note F[4])	2		8	
Cash disbursed and stock issued pursuant to the exercise of Dynell employee options (Note D[4])	3		(18)	
Net (loss) for the year ended September 30, 1980				(2,099)
Balance—September 30, 1980	2,917	29	7,141	(6,751)
Sale of stock in public offering	450	5	2,020	
Exercise of warrants (Note C)	10		50	
Shares issued on conversion of subordinated convertible notes (net of deferred borrowing costs) (Note C)	33		71	
Sale of stock pursuant to the exercise of employee incentive options (Note F[4])	6		17	
Compensation on grant of options at less than quoted market price			12	
Cash disbursed and stock issued pursuant to the exercise of Dynell employee options (Note D[4])	2		(4)	
Net (loss) for the year ended September 30, 1981				(1,181)
Balance—September 30, 1981	3,419	34	9,307	(7,932)
Sale of units (Note F[2])	78	1	666	
Costs in connection with sale of units (Note F[2])			(95)	
Exercise of warrants (Note C)	2		13	
Shares issued on conversion of subordinated convertible notes (net of deferred borrowing costs) (Note C)	51		109	
Sale of stock pursuant to the exercise of employee incentive options (Note F[4])	12		26	
Reacquisition of stock from the Company's senior vice-president (Note F[3]) (b))	(25)		(108)	
Net (loss) for the year ended September 30, 1982				(865)
Balance—September 30, 1982	3,538	$35	$9,918	$(8,797)

The accompanying notes to consolidated financial statements are an integral part hereof.

Consolidated Statements of Changes in Financial Position

(A Development Stage Company)

	October 1, 1976 (Inception) to September 30, 1982	Year Ended September 30, 1982	1981	1980
	(Pro forma)			
Financial Resources were Applied to:				
Operations:				
Net loss	$ 8,797	$ 865	$1,181	$ 2,099
Less items not requiring outlay of working capital:				
Depreciation	1,392	150	219	359
Amortization	132	13	9	65
Deferred compensation	153	33	37	33
	1,677	196	265	457
Working capital applied to operations	7,120	669	916	1,642
Acquisition of factory, engineering and other equipment	1,773	168	40	94
Notes receivable on sale of stock	239			
Reduction of note payable to Norden Systems, Inc.	1,500		500	1,000
Retirement of stock	108	108		
Conversion of convertible debt (net of deferred borrowing costs)	1,772	109	71	1,592
Other	181		(49)	127
Increase (decrease) in working capital	843	(245)	697	(2,855)
Total	$13,536	$ 809	$2,175	$ 1,600
Financial Resources were Provided by:				
Contribution of capital by Dynell Electronics Corporation	$ 2,664			
Sale of common stock—net	5,659	$ 611	$2,092	$ 8
Reduction of long-term note receivable	89	89		
Long-term borrowings (net of $168,000 deferred borrowing costs)	3,332			
Warrants issued in connection with long-term borrowing	8			
Conversion of convertible debt (net of deferred borrowing costs)	1,772	109	71	1,592
Proceeds from disposal of fixed assets	12		12	
Total	$13,536	$ 809	$2,175	$ 1,600
Changes in Working Capital Components:				
Increase (decrease) in current assets:				
Cash	$ 228	$ (23)	$ 94	$ (640)
Investment in short-term commercial paper	450	80	120	(2,250)
Accounts receivable	668	254	189	110
Inventories		(256)	151	69
Accrued interest and other current assets	45		30	(48)
	1,391	55	584	(2,759)
Increase (decrease) in current liabilities:				
Accounts payable and accrued expenses	366	278	(108)	58
Customer deposits	9	(14)	(43)	(8)
Accrued payroll and related employee benefits	173	36	38	46
	548	300	(113)	96
Increase (Decrease) in Working Capital	$ 843	$(245)	$ 697	$(2,855)

The accompanying notes to consolidated financial statements are an integral part hereof.

Consolidated Statements of Operations

(A Development Stage Company)

	October 1, 1976 (Inception) to September 30, 1982	Year Ended September 30, 1982	1981	1980
	(Pro forma)			
Sales (Note G)	$ 4,953	$2,643	$ 1,018	$ 705
Cost of sales (exclusive of research and development costs)	5,013	2,287	829	700
Research and development costs	4,083	379	626	1,097
Selling, general and administrative expenses	4,950	903	930	964
Total	14,046	3,569	2,385	2,761
Balance	(9,093)	(926)	(1,367)	(2,056)
Interest income	963	85	198	280
Other income	40		40	
Interest (expense)	(707)	(24)	(52)	(323)
Net (loss)	$ (8,797)	$ (865)	$(1,181)	$(2,099)
(Loss) per common share	$(4.14)	$(.25)	$(.37)	$(1.00)
Average number of shares outstanding (Note H)	2,127	3,399	3,225	2,091

The accompanying notes to consolidated financial statements are an integral part hereof.

Notes to Consolidated Financial Statements

(A Development Stage Company)

(Note A)—The Company and its Significant Accounting Policies:

[1] Robotic Vision Systems, Inc. ("RVSI") was spun off on December 27, 1977 from its then parent company, Dynell Electronics Corproation ("Dynell") to Dynell stockholders under a plan of reorganization; 647,732 shares of RVSI common stock were issued pursuant to the plan. Prior to December 27, 1977 all capital was contributed to RVSI by Dynell.

[2] The Company is in the development stage, engaged principally in selling and manufacturing products requiring the use of its three-dimensional optical vision technology, in further developing the process and in developing other projects. Prior to December 27, 1977 RVSI was operated by Dynell solely as a sales entity for such products, and Dynell bore the cost of research and development, manufacturing and certain administrative costs. The cumulative financial statements have been compiled on a pro forma basis as if RVSI had performed all of the aforementioned functions from inception on October 1, 1976.

Research and development expenditures associated with the Company's projects expended by Dynell prior to October 1, 1976 amounted to $3,356,000 on a cumulative basis.

[3] The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Intercompany transactions, investments and advances have been eliminated in consolidation. Through September 30, 1982, the subsidiaries have had insignificant assets and insignificant operations.

[4] Depreciation of equipment is computed on the straight line method over estimated lives of two to eight years. The investment tax credit relating to purchases of equipment is accounted for on the flow-through method.

[5] A portion of the Company's income is derived from long-term cost plus fixed fee contracts with the United States government which are accounted for on the percentage-of-completion method whereby the Company recognizes income equal to the costs incurred plus a proportion of the fixed fee. Revenues are billed in accordance with the terms of each contract. The Company estimates that its unbilled revenues at September 30, 1982 will become billable during the ensuing twelve months. See Note D[5] with respect to the accounting policy for two research and development contracts.

[6] The Company has in effect a pension plan for the benefit of eligible employees; the costs of the plan are funded on an actuarial basis (Note D[3]).

(Note B)—Factory, Engineering, and Other Equipment:

Factory, engineering and other equipment comprise the following:

	September 30, 1982	September 30, 1981
Three-dimensional copying equipment	$ 81,000	$ 816,000
Factory and computer equipment	598,000	458,000
Automobiles	24,000	18,000
Furniture, fixtures, office and cafeteria equipment	63,000	46,000
	766,000	1,338,000
Less accumulated depreciation	395,000	985,000
Balance	$371,000	$ 353,000

(Note C)—Variable Rate Subordinated Convertible Notes:

In July 1979 the Company sold $2,000,000 of variable rate subordinated notes due July 30, 1984 and convertible into common shares of the Company at $2.25 per share any time prior to the maturity date. The interest rate is 6% per annum for the first two years and 10% per annum for the final three years. Costs related to the sale are being amortized over the term of the notes. Such costs include $8,000 representing the estimated fair value of warrants to acquire 80,000 shares of the Company's common stock (which were issued to parties effectuating the placement of the notes). The warrants are exercisable at any time prior to July 30, 1984 at $2.25 per share.

The notes are subordinated to all indebtedness of RVSI other than trade debt or indebtedness to United Technologies Corporation or affiliates thereof (Note D[7]).

In September 1980 pursuant to a conversion offer, $1,700,000 of the notes were converted into 755,547 shares of the Company's common stock. In connection therewith, note holders accepting the offer were issued warrants expiring on August 24, 1983 to purchase 1,000 shares of the Company's common stock for each $10,000 principal amount of notes converted (an aggregate of 170,000 shares) at an exercise price of $5.00 per share. Through September 30, 1982 12,500 warrants have been exercised. Subsequent to September 1980 an additional $189,750 in notes were converted into 84,333 shares of the Company's common stock.

(Note D)—Commitments:

[1] Employment Agreements:

An employment agreement with the Company's president provides for a minimum annual salary, which currently amounts to $75,000. In addition, he and the former senior vice-president are to receive annual deferred compensation payments, commencing on or after January 1, 1988 and May 1, 1988, respectively, equal to 50% of their actual annual salary; such deferred compensation is to continue for a period of time equal to their actual employment. The Company charged $33,000, $37,000 and $33,000 to operations for the years ended September 30, 1982, September 30, 1981, and September 30, 1980, respectively, representing the present value of its obligation plus an interest factor of 7% per annum. The agreements also provide for partial salary payments in the event of permanent disability or death.

[2] Leases:

The Company leases factory and office space through December 31, 1983 at a maximum rental of $13,057 per month.

Rent expense included in operations for the years ended September 30, 1982, September 30, 1981, and September 30, 1980 aggregated $147,000, $147,000 and $192,000, respectively.

[3] Pension Plan:

The Company has implemented a noncontributory pension plan. In connection therewith it charged $40,000, $31,000, and $28,000 to operations for the years ended September 30, 1982, September 30, 1981, and September 30, 1980, respectively; such charges include amortization of past service costs over a ten-year period. However, the amount of the contribution funded or to be funded by the Company in the respective periods is less than the foregoing amount. Past service costs at September 30, 1981 aggregated approximately $154,000.

The actuarial value of vested and nonvested benefits are estimated to be $152,335 and $23,132, respectively, as at October 1, 1981 which is the most recent valuation date for which the information is available. As at that date, net assets available for benefits were $349,993. The assumed rate of return used in determining the actuarial present value of plan benefits was 6.75%.

[4] Shares Issued and Cash Paid Pursuant to Commitments Relating to Dynell Employee Options and Dynell Employee Purchase Plans:

In connection with the spin-off referred to in Note A[1], the Company was obligated to issue shares of its common stock without cash consideration to certain former employees and to pay cash and to issue shares of its common stock without cash consideration to certain of its own employees; such obligations were fulfilled by September 30, 1981.

[5] Sales Contracts:

Two contracts were received in July 1979 and December 1981 for the development of equipment which, in the opinion of management, is in accord with its general research and development objectives. Accordingly, the Company charged costs incurred under these contracts to research and development until such time as it achieved the level of development necessary to fulfill the contract requirements. Thereafter, costs incurred were inventoried but in no event did such inventory costs exceed the contract price. At September 30, 1982, costs previously inventoried on these contracts were charged to cost of sales.

[6] License Agreements:

RVSI granted a license to Dynell and United Technologies Corporation ("United") under RVSI's patents related to its three-dimensional optical vision techniques. The license, which is exclusive (except as to RVSI) in the United States and nonexclusive in the rest of the world, shall continue until the expiration of all the licensed patents (approximately 1994) and shall be royalty free until payment in full of the notes described in Note D[7]. Upon payment of the notes the royalty shall be 3% of the net sales price for each licensed product sold thereafter.

In March 1982 RVSI entered into a licensing agreement with Nichimen Co., Ltd. of Japan for certain of RVSI's products for a two-year period with an automatic renewal provision. No royalties have been earned to date.

[7] Revolving Credit Agreement:

On or about the date of the spin-off referred to in Note A[1], a subsidiary of United acquired all of the outstanding stock of Dynell. In connection therewith United agreed that it or a United subsidiary will lend up to $2,000,000 to RVSI in amounts of not less than $50,000 bearing interest at the prime rate of Citibank, N.A. Repayment of principal is due ten years from the effective date of the acquisition.

The borrowings are subordinate to any other indebtedness incurred by RVSI with certain exceptions. While such debt is outstanding certain restrictions exist as to cash dividends and repurchase of RVSI common stock. In the event of nonpayment of a note when due or on the happening of an event of default, as defined in the note, the note will become due and payable or, at the election of the holder, the note may be converted into a majority of the number of shares of RVSI's common stock, both outstanding and reserved for issuance, as of such date.

At September 30, 1982 there is no outstanding indebtedness under this agreement.

(Note E)—Income Taxes:

RVSI's loss carryover at September 30, 1982 is approximately $6,656,000 ($1,144,000 expiring in 1993, $1,683,000 expiring in 1994, $1,891,000 expiring in 1995, $1,139,000 expiring in 1996, and $799,000 expiring in 1997). Such carryover differs from the deficit accumulated during the development stage shown in the accompanying financial statements principally because of (i) losses approximating $1,614,000 sustained prior to the spin-off date and included in Dynell's consolidated income tax return, and (ii) the excess (approximately $400,000) of the fair value of equipment transferred from Dynell at the spin-off date over its depreciable basis for tax purposes.

(Note F)—Stockholders' Equity:

[1] In connection with a sale of stock to the public in November 1980, RVSI issued to the underwriter five-year warrants to purchase 45,000 additional shares of its common stock at a price of $6.60 per share.

[2] In March 1982 RVSI sold to its stockholders 78,463 units at a price of $8.50 per unit and received net proceeds of $572,000. Each unit consisted of one share of common stock and one warrant to purchase one additional share of common stock at $7 through March 11, 1984 and thereafter at $10 through March 11, 1986.

[3] (a) On January 2, 1978, the Company sold 75,000 shares of its common stock to its president at a price of $2 per share. The Company received a 6% nonrecourse note in the amount of $150,000 due on December 31, 1980, of which $1,000 was subsequently paid. The due date of the note is automatically extended to the extent that the president continues in the employ of RVSI beyond December 31, 1980,

but in no event is it to be extended beyond December 31, 1983. Such transaction is considered to have taken effect at the spin-off date.

The note is collateralized by 75,000 shares of the president's stock which, in the event of default on the note, would be the only satisfaction the Company has against him. The president cannot exercise any voting rights with respect to stock which is at the time subject to the pledge without the prior consent of the Company.

(b) On May 1, 1978, the Company sold 25,000 shares of its common stock to its senior vice-president at a price of $3.56 (approximate market value) per share, an aggregate of $89,000. The Company received a 6% nonrecourse note in the amount of $89,000 due on April 30, 1981. The due date of the note was automatically extended to the extent that the senior vice-president continued in the employ of RVSI beyond April 30, 1981. By reason of the termination of the senior vice-president's employment with the Company, the note became due and payable on January 23, 1982. Since the note was not paid on that date, such 25,000 shares have been reacquired by the Company.

[4] The Company adopted an incentive stock option plan pursuant to which it has authorized for issuance, upon the exercise of options, an aggregate of 300,000 shares of its common stock. All employees of the Company and its subsidiaries are eligible to receive options under the plan. Option prices are to be determined by the Board of Directors or the stock option committee at the time of issuance of options, and need be no less than the market prices for the stock. The duration and exercise intervals of options are also within the discretion of the Board of Directors or the committee.

	September 30,		
	1982	1981	1980
Options outstanding	241,095	175,290	86,960
Option price	$2.00 to $8.69	$2.00 to $16.38	$2.00 to $5.81
Total option price	$1,312,000	$1,520,000	$291,000
Options exercisable	18,995	4,285	3,385
Options exercised	12,025	6,025	2,625
Exercise price	$2.00 to $3.56	$2.00 to $4.19	$2.00 to $3.56
Total exercise price	$26,000	$17,000	$8,000

[5] On April 5, 1982 the Board of Directors of the Company also adopted a nonqualified incentive stock option plan pursuant to which it has authorized for issuance, upon the exercise of options, an aggregate of 100,000 shares of its common stock. The plan was approved by the Company's stockholders at the annual meeting held June 30, 1982. All employees and nonemployee Directors of the Company and its subsidiaries are eligible to receive options under the plan. Option prices are to be determined by the Board of Directors or the stock option committee at the time of issuance of options, and need not be equivalent or related to the market prices for the stock. The duration and exercise intervals of options are also within the discretion of the Board of Directors or the committee.

At September 30, 1982 options for the purchase of 4,500 shares of stock at an option price of $4.69 per share were outstanding of which no shares were exercisable. No options were exercised during the year ended September 30, 1982.

[6] Shares reserved for issuance at September 30, 1982:

Pursuant to conversion of variable rate subordinated convertible notes (Note C)	49,000
Pursuant to warrants (Note C)	237,500
Pursuant to warrants (Note F[1])	45,000
Pursuant to warrants (Note F[2])	78,463
Outstanding options pursuant to incentive stock option plan (Note F[4])	241,095
Options available for grant pursuant to incentive stock option plan (Note F[4])	38,230
Outstanding options pursuant to stock option plan (Note F[5])	4,500
Options available for grant pursuant to stock option plan (Note F[5])	95,000
Total	788,788

(Note G)—Sales to Major Customers:

Sales to the United States government aggregating $1,664,000, $815,000, and $335,000 accounted for 63%, 80%, and 48% of total sales for the years ended September 30, 1982, September 30, 1981, and September 30, 1980, respectively. Sales to a major automotive company and Cummins Engine Company aggregating $582,000 and $357,000 accounted for 22% and 14%, respectively, of total sales for the year ended September 30, 1982.

(Note H)—Loss Per Share:

The average number of shares used in the computation of loss per share does not include 75,000 shares sold to the Company's president (Note F[3](a)) or shares issuable pursuant to options, warrants, and convertible debt, since their effect on loss per share is anti-dilutive.

Accountants' Opinion

Board of Directors and Stockholders
Robotic Vision Systems, Inc.
Melville, New York

We have examined the consolidated balance sheets of Robotic Vision Systems, Inc. and subsidiaries (a development stage company) as at September 30, 1982 and September 30, 1981 and the related consolidated statements of changes in stockholders' equity accounts, operations, and changes in financial position for each of the years ended September 30, 1982, September 30, 1981, and September 30, 1980. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements enumerated above present fairly the consolidated financial position of Robotic Vision Systems, Inc. and subsidiaries at September 30, 1982 and September 30, 1981 and the consolidated results of their operations and changes in their financial position for each of the years ended September 30, 1982, September 30, 1981, and September 30, 1980, in conformity with generally accepted accounting principles applied on a consistent basis.

We have also examined the pro forma statements of operations, changes in stockholders' equity accounts and changes in financial position for the period from October 1, 1976 (inception) to September 30, 1982. In our opinion, such pro forma statements have been property compiled on the basis indicated in Note A[2].

November 24, 1982

VIRATEK, INC.

Consolidated Statements of Operations

(A Development Stage Enterprise)

For the years ended November 30, 1982 and 1981, from August 1, 1980 (inception) through November 30, 1980 and from August 1, 1980 (inception) through November 30, 1982

	Period			
	Years ended November 30		August 1, 1980 (inception) to November 30	
	1982	1981	1980	1982
Sales—Trade	$ 239	$ 125	$ —	$ 364
Sales to affiliates (Note 7)	213	—	—	213
Total sales	452	125	—	577
Cost of sales	306	84	—	390
Gross profit	146	41	—	187
Research and development costs	1,950	1,497	155	3,602
Interest (income), net	(89)	(211)	—	(300)
Other (income) expenses, net (Note 4)	133	(28)	12	117
Total non-operating expenses	1,994	1,258	167	3,419
Net loss	$(1,848)	$(1,217)	$(167)	$(3,232)
Net loss per common share (Note 1)	$ (.63)	$ (.46)	$ (.07)	

The accompanying notes are an integral part of these statements.

Consolidated Statements of Shareholders' Equity

(A Development Stage Enterprise)

From August 1, 1980 (inception) through November 30, 1980 and for the two years ended November 30, 1982

	Common Stock Number of Shares	Common Stock Amount	Additional Capital	Deficit Accumulated During the Development Stage	Total
Balance at August 1, 1980 (inception)	—	$ —	$ —	$ —	$ —
Capitalization of the Company related to contribution of assets by ICN (Note 2)	2,300	230	397	—	627
Net loss	—	—	—	(167)	(167)
Balance at November 30, 1980	2,300	230	397	(167)	460
Net proceeds from common stock offering (Note 3)	570	57	3,334	—	3,391
Net loss	—	—	—	(1,217)	(1,217)
Balance at November 30, 1981	2,870	287	3,731	(1,384)	2,634
Proceeds from exercise of stock options	97	10	299	—	309
Net loss	—	—	—	(1,848)	(1,848)
Balance at November 30, 1982	2,967	$297	$4,030	$(3,232)	$1,095

The accompanying notes are an integral part of these statements.

Consolidated Statements of Changes in Financial Position

(A Development Stage Enterprise)

For the years ended November 30, 1982 and 1981, from August 1, 1980 (inception) through November 30, 1980 and from August 1, 1980 (inception) through November 30, 1982

	Period			
	Years ended November 30		August 1, 1980 (inception) to November 30	
	1982	1981	1980	1982
Sources (uses) of working capital:				
Net loss	$(1,848)	$(1,217)	$(167)	$(3,232)
Depreciation and amortization	73	21	—	94
Disposal of net Brazilian property, plant and equipment	25	—	—	25
(Increase) decrease in deferred costs	(10)	165	(213)	(58)
Additions to property, plant & equipment	(115)	(362)	(22)	(499)
Additions to patents and trademarks	(22)	(34)	(166)	(222)
(Increase) decrease in other assets	11	(11)	—	—
Total Uses	(1,886)	(1,438)	(568)	(3,892)
Contributed capital by ICN (Note 2)	—	—	627	627
Net proceeds from common stock offering (Note 3)	—	3,391	—	3,391
Proceeds from exercise of stock options	309	—	—	309
Total Sources	309	3,391	627	4,327
Increase (Decrease) in Working Capital	$(1,577)	$ 1,953	$ 59	$ 435

Analysis of changes, increase (decrease), in components of working capital:

Cash	$(1,367)	$ 1,647	$ 9	$ 289
Receivables	(162)	183	224	245
Inventories	(26)	72	101	147
Prepaid expenses and other current assets	(34)	154	21	141
Notes payable	49	(23)	(26)	—
Accounts payable	(60)	(65)	(250)	(375)
Accrued liabilities	23	(21)	(14)	(12)
Income taxes payable	—	6	(6)	—
Increase (Decrease) in Working Capital	$(1,577)	$ 1,953	$ 59	$ 435

The accompanying notes are an integral part of these statements.

Consolidated Balance Sheets

(A Development Stage Enterprise)

November 30, 1982 and 1981

Assets	1982	1981
Current Assets:		
Cash (including certificates of deposit of $300,000 in 1982 and $1,600,000 in 1981)	$ 289	$1,656
Receivables, net (Note 8)	68	375
Receivables from affiliates	177	32
Inventories (Notes 1 and 8)	147	173
Prepaid expenses and other current assets (Note 8)	141	175
Total current assets	822	2,411
Property, Plant and Equipment, net (Notes 1 and 8)	401	363
Deferred Costs	58	48
Patents & Trademarks, Net of Accumulated Amortization	201	200
Other Assets	—	11
Total Assets	$1,482	$3,033

Liabilities and Shareholders' Equity	1982	1981
Current Liabilities:		
Notes payable	$ —	$ 49
Accounts payable	270	292
Accounts payable to affiliates	105	23
Accrued liabilities	12	35
Total current liabilities	387	399
Commitments and Contingencies		
Shareholders' Equity (Notes 1, 2, 3, 5 and 7):		
Preferred stock: $.10 par value; 1,000,000 shares authorized; none issued	—	—
Common stock: $.10 par value; 9,000,000 shares authorized; 2,967,000 outstanding in 1982 (2,870,000 in 1981)	297	287
Additional capital	4,030	3,731
Deficit accumulated during the development stage (Note 1)	(3,232)	(1,384)
Total shareholders' equity	1,095	2,634
Total Liabilities and Shareholders' Equity	$1,482	$3,033

The accompanying notes are an integral part of these balance sheets.

Notes to Consolidated Financial Statements

(A Development Stage Enterprise)

November 30, 1982

(1) Summary of Significant Accounting Policies:

Viratek, Inc. (the Company) was incorporated on August 1, 1980 and is a development stage enterprise which is 65 percent owned by ICN Pharmaceuticals, Inc. (ICN). The Company was organized to develop, produce and market compounds derived from or related to the components of nucleic acids which are to be used in the treatment of viral as well as certain other diseases. The Company's most promising compounds are patented. The leading compound, known as ribavirin, has been approved as an Investigational New Drug (IND) by the Food and Drug Administration (FDA) and testing of aerosolized ribavirin against human influenza is in the late stages. While the Company has had limited sales of this product in Brazil, Mexico and Eastern European countries, success of the Company is dependent upon obtaining regulatory approval to market its products in the United States and Western Europe; and while the Company expects the FDA to approve its New Drug Application (NDA) in 1983, no assurance can be given as to when, or if, such approval will be obtained or the ultimate direct and indirect costs associated therewith. Further, during the period required to commercially develop and market its compounds, the Company will require substantial amounts of additional funds in order to continue its activities, and no assurance can be given that such funds will be available.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned foreign subsidiary, ICN Produtos Farmaceuticos Ltda. (Brazil) (through July, 1982, the date of disposition of this subsidiary—See Note 4). All significant intercompany balances and transactions have been eliminated.

Translation of Foreign Currency Financial Statements

The accounts of the foreign subsidiary were translated in accordance with Statement of Financial Accounting Standards No. 8.

Inventories

Inventories, which include material, direct labor and factory overhead, are stated at the lower of cost (first-in, first-out) or market.

Property, Plant and Equipment

Depreciation is provided principally on the straight-line method over the estimated useful lives of the related assets as follows:

Machinery and equipment	10 years
Aerosol machines	10 years
Furniture and fixtures	5-10 years
Automobiles	5 years

Repairs and maintenance which are not considered betterments and do not extend the useful life of the property are charged to expense as incurred. Upon sale or retirement, the costs and related accumulated depreciation are eliminated from the respective accounts, and the resulting gain or loss is recorded in income.

Patents and Trademarks

Patents and trademarks are amortized over 17 years, their estimated useful lives.

Per Share Information

Loss per common share is based on the weighted average number of common shares outstanding of 2,919,000 in 1982, 2,623,000 in 1981 and 2,300,000 in 1980. Shares issuable under stock option plans and warrants were not included since the effect would have been antidilutive.

(2) Capitalization of the Company Related to the Contribution of Assets by ICN:

The Company's initial common stock was issued pursuant to an asset transfer agreement dated November 26, 1980, and amended February 25, 1981. The agreement provided for the exchange of certain contributed assets of ICN and its subsidiaries relating to the development of nucleic acid compounds and their analogs, ICN's assumption of the Company's accounts payable accrued through November 30, 1980 and ICN's assumption of certain offering costs in excess of approximately 15% of the gross proceeds of the Company's initial public offering. The contributed assets included cash, transferable patents, trademarks and distribution agreements and all other transferable intangible rights related to such compounds and analogs, certain inventories, equipment and all of the outstanding capital stock of ICN Produtos Farmaceuticos Ltda., a Brazilian subsidiary of ICN, all of which totaled $627,000 at November 30, 1980 ($230,000 was credited to common stock and $397,000 was credited to additional capital). The bases for the values of transferred assets were the values recorded in the accounting records of ICN and subsidiaries and both the cost and accumulated amortization and depreciation, where appropriate, were transferred.

(3) Net Proceeds From Common Stock Offering:

On May 7, 1981, the Company successfully sold 570,000 shares of its common stock to the public in a common stock offering. The net proceeds to the Company from the offering are summarized as follows:

Sale of 570,000 common shares at $7.00 each	$3,990,000
Underwriting discounts and commissions	399,000
Underwriters' fees	76,000
Attorney fees	407,000
Accounting fees	69,000
Printing costs	48,000
Other	34,000
Total offering costs incurred by the Company	1,033,000
Less costs paid by ICN pursuant to their agreement with the Company to assume all costs in excess of 15 percent of the gross proceeds from the offering	(434,000)
Net offering costs borne by the Company	599,000
Net proceeds to the Company	$3,391,000

(4) Foreign Operations:

In July 1982, the Company sold the capital stock of its Brazilian subsidiary. The consideration received by the Company consisted of a nominal amount of cash and the assumption of all the subsidiary's obligations by the buyer. The gain on sale of the subsidiary of $42,000 (primarily represented by the subsidiary's net deficit which had been recorded by the Company in prior periods) and the results of its operations for all periods presented are reflected under the caption "other (income) expenses, net" in the accompanying Consolidated Statements of Operations. Sales and net income (loss) of the Brazilian subsidiary for the periods ending November 30, 1982, 1981, and 1980 were $170,000, $898,000, $88,000 and $(131,000), $8,000, $(12,000), respectively.

(5) Stock Options and Warrants:

At November 30, 1982, the Company has reserved 153,000 shares of its common stock for issuance to employees and directors of the Company and its affiliates (including ICN) under the Company's nonqualified 1980 Employee Stock Option Plan. Options are exercisable during a four-year period beginning one year after date of grant and expire five years after grant date. At November 30, 1982, options under this plan were exercisable to purchase 140,000 shares of common stock.

In addition, during 1981 the Company adopted a nonqualified 1981 Stock Option Plan pursuant to which 25,000 shares of common stock have been reserved for issuance to members of the Company's Scientific Advisory Board and other consultants to the Company. Options are exercisable after one year of continuous service and expire five years after grant date. At November 30, 1982, options under this plan were exercisable to purchase 10,250 shares of common stock.

During 1982, the shareholders of the Company approved the 1981 Employee Incentive Stock Option Plan under which 100,000 shares of common stock have been reserved for granting to key employees, officers and directors of the Company. The exercise price of these options may not be less than the fair market value of the stock at the date of grant and may not have a term exceeding ten years. At November 30, 1982, options under this plan were exercisable to purchase 20,000 shares of common stock.

The following is a summary of the activity relating to the stock option plans for the year ended November 30, 1982:

	Number of Option Shares	Option Price/Share
1980 Employee Stock Option Plan		
Outstanding as of November 30, 1981	240,000	$2.00-$7.00
Issued	—	—
Exercised	87,000	$2.00-$7.00
Cancelled	13,000	$7.00
Outstanding as of November 30, 1982	140,000	$2.00-$7.00
1981 Stock Option Plan		
Outstanding as of November 30, 1981	22,750	$7.00-$7.75
Issued	—	—
Exercised	—	—
Cancelled	12,500	$7.00
Outstanding as of November 30, 1982	10,250	$7.00-$7.75
1981 Employee Incentive Stock Option Plan		
Outstanding as of November 30, 1981	—	—
Issued	55,000	$7.00-$7.75
Exercised	10,000	$7.50
Cancelled	15,000	$7.00
Outstanding as of November 30, 1982	30,000	$7.50-$7.75

During 1982 the shareholders of the Company also approved in principle a "Special Stock Option" and Stock Option Grants Subject to FDA Action ("1982 FDA Option Plan"). The Special Stock Option is a grant to Mr. Milan Panic, a director of the Company and the Chairman of the Board and principal executive officer of ICN, of a five-year option to acquire up to 150,000 shares of the Company's common stock at $7.00 per share. The percentage of the total shares covered by the option which Mr. Panic could actually acquire would be equal to the percentage which capital, privately raised through the special assistance of Mr. Panic, bears to $50,000,000; however, none of the option would be exercisable unless Mr. Panic's efforts succeed in providing the Company with at least $10,000,000 in new capital.

The 1982 FDA Option Plan relates to five-year options for an aggregate of 100,000 shares of the Company's Common Stock, at $7.00 per share. The Board of Directors has authorized the issuance of stock options for 50,000 shares to Dr. Smith, the President of the Company, and options for 25,000 shares to a director of the Company. None of the options granted under the 1982 FDA Option Plan would be exercisable unless and until Virazole is approved by the FDA for at least one specified use.

In connection with the public offering described in Note 3, the Company sold to the representatives of the underwriters, for $.01 per warrant, Common Stock Purchase Warrants to purchase a total of 57,000 shares of the Company's common stock exercisable during a four-year period commencing 12 months after the date of the public offering at a price equal to $8.40 per share. The warrants are transferable only to persons who are both officers and shareholders of the representatives, are subject to customary anti-dilution provisions and carry certain rights to cause registration by the Company at its expense of the underlying shares. For the life of such warrants, the holders are given, at nominal cost, the opportunity to profit from a rise in the market price of the common stock of the Company with a resulting dilution in the interest of the other shareholders. At November 30, 1982 all the warrants were exercisable.

(6) Income Taxes:

The Federal Income tax return of the Company for the year ended November 30, 1982, will reflect a tax operating loss carryforward, including the current year, of approximately $3,650,000 which expires in varying amounts through 1997 and an investment tax credit carryforward of $44,000 which expires in varying amounts through 1990. For financial reporting purposes no benefit has been reflected relating to these operating loss carryforwards.

(7) Related Party Transactions:

As described in Note 2, the Company was initially capitalized by the contribution of certain assets by ICN. The Company rents its Covina facility from ICN and paid rent to ICN (ncluding charges for utilities and maintenance) of $51,396, $53,646, and $10,332 during 1982, 1981 and 1980, respectively.

The Company's current rental agreement with ICN for its Covina facility provides for a total monthly rental of $4,283. The Company also paid ICN $32,000 in 1981, and $6,000 in 1980, for warehouse facilities in Irvine, California. In addition, the Company paid ICN $18,000, $25,666 and $5,656 in 1982, 1981, and 1980, respectively for other charges such as communication costs and furniture rental.

Sales to affiliates in the accompanying Consolidated Statements of Operations represent product sales to an ICN subsidiary in Mexico at prices similar to those that would be charged to a non-affiliated company.

The Company has an arrangement whereby the employer of one of its directors is paid $25,000 annually for consultation services provided by the director in connection with the overseeing of clinical studies and other administrative assistance given to the Company, and the Board of Directors has approved the granting to this Director of an option to purchase 25,000 shares of the Company's common stock at $7.00 per share under the 1982 FDA Option Plan. This and other outside directors have provided legal and other consultation services to the Company, which amounts have totaled $23,000, $10,000 and $1,000 for the periods ended November 30, 1982, 1981 and 1980 and have been granted stock options for the purchase of 100,500 shares of the Company's common stock at prices ranging from $2.00 to $7.00.

In addition, the Company paid approximately $140,000 in 1981 to a company to produce its first 103 aerosol machines. An officer of ICN is also an officer of that company; and management believes that these transactions, as well as the ones discussed above, were conducted on terms no more nor less favorable to the Company than could have been obtained elsewhere.

(8) Selected Balance Sheet Information:

Receivables, net consist of the following:

	1982	1981
Trade accounts receivable (less $34,000 discounted with a foreign bank in 1981)	$57,000	$231,000
Receivables from officers, employees and travel advances	—	37,000
Other receivables, primarily interest in 1981	11,000	107,000
	$68,000	$375,000

Inventories consist of the following:

	1982	1981
Raw materials	$ 28,000	$ 94,000
Work-in-process	50,000	39,000
Finished goods	69,000	40,000
	$147,000	$173,000

Prepaid expenses and other current assets consist of the following:

	1982	1981
Deposits for clinical trials	$ —	$154,000
Prepaid promotional material	65,000	—
Other	76,000	21,000
	$141,000	$175,000

The deposits for clinical trials at November 30, 1981 consisted of amounts paid to several medical schools to conduct a multicenter aerosol study on influenza and respiratory syncytial virus in fiscal 1982.

Property, plant and equipment, net consist of the following:

	1982	1981
Machinery and equipment	$384,000	$277,000
Aerosol machines	152,000	147,000
Furniture and fixtures	15,000	35,000
Automobiles	4,000	6,000
	555,000	465,000
Less: Accumulated depreciation	154,000	102,000
	$401,000	$363,000

Report of Independent Public Accountants

To the Shareholders and Board of Directors of
Viratek, Inc.:

We have examined the consolidated balance sheets of Viratek, Inc. and subsidiary (a Delaware Corporation in the development stage and majority owned subsidiary of ICN Pharmaceuticals, Inc.) as of November 30, 1982 and 1981, and the related consolidated statements of operations, shareholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The financial statements of Viratek, Inc. and subsidiary for the period ended November 30, 1980, were examined by other auditors whose report dated January 30, 1981, expressed an unqualified opinion on those statements.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Viratek, Inc. and subsidiary as of November 30, 1982 and 1981, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

February 10, 1983.

IV

FORMER DEVELOPMENT STAGE ENTERPRISE

A development stage enterprise that has commenced principal operations may reach the stage when revenue from those operations becomes significant. At that time, the enterprise ceases being a development stage enterprise. Statement No. 7 requires such an enterprise to disclose in the financial statements for the first year in which it is an established operating enterprise that in prior years it had been in the development stage.

An example is presented below of an enterprise that recently ceased being a development stage enterprise. The financial statements for the last year in which it is a development stage enterprise are presented first. The financial statements of the first year in which it is an established operating enterprise are presented next.

LAST YEAR OF DEVELOPMENT STAGE

GENETIC SYSTEMS CORPORATION

Consolidated Statement of Operations

(A Development Stage Enterprise)

For the period from November 13, 1980 (inception) to December 31, 1981

Syva contract revenue (note 2)	$ 277,083
Expenses incurred during the development stage, principally research and development costs	1,410,974
Operating loss	1,133,891
Interest income	732,557
Net loss	$ 401,334
Net loss per average common share outstanding	$.04

See accompanying notes to consolidated financial statements.

Consolidated Balance Sheet

(A Development Stage Enterprise)

December 31, 1981

Assets	
Current assets:	
Cash and cash equivalents	$6,655,505
Accrued interest receivable	395,894
Lease deposit, currently refundable (note 4)	50,000
Prepaid expenses and other assets	43,559
Total current assets	7,144,958
Leasehold improvements, equipment and furniture (notes 3 and 4)	1,876,892
Lease deposit (note 4)	150,000
	$9,171,850
Liabilities and Shareholders' Equity	
Current liabilities:	
Current installments of obligations under capital leases (note 4)	134,802
Accounts payable	500,215
Deferred contract revenue (note 2)	251,203
Total current liabilities	886,220
Installment note payable	53,049
Obligations under capital leases, excluding current installments (note 4)	651,979
Shareholders' equity (note 6):	
Common stock, par value $.01 per share. Authorized 30,000,000 shares; issued 13,700,000 shares	137,000
Additional paid-in capital	7,844,936
Deficit accumulated during the development stage	(401,334)
Total shareholders' equity	7,580,602
Commitments (notes 2 and 4)	
	$9,171,850

See accompanying notes to consolidated financial statements.

Consolidated Statement of Changes in Financial Position

(A Development Stage Enterprise)

For the period from November 13, 1980 (inception) to December 31, 1981

Uses of working capital:	
Net loss	$ 401,334
Purchase of leasehold improvements, equipment and furniture	1,876,892
Lease deposit	200,000
Current installments and payments of obligations under capital leases	151,481
Increase in working capital	6,258,738
	$8,888,445
Sources of working capital:	
Lease deposit currently refundable	50,000
Increase in obligations under capital leases	803,460
Installment note payable	53,049
Proceeds from sales of common stock, net of expenses of offering	7,981,936
	$8,888,445

Changes in components of working capital:	
Increase in current assets:	
Cash and cash equivalents	6,655,505
Accrued interest receivable	395,894
Lease deposit, currently refundable	50,000
Prepaid expenses and other assets	43,559
	7,144,958
Increase in current liabilities:	
Current installments of obligations under capital leases	134,802
Accounts payable	500,215
Deferred contract revenue	251,203
	886,220
Increase in working capital	$6,258,738

See accompanying notes to consolidated financial statements.

Consolidated Statement of Shareholders' Equity

(A Development Stage Enterprise)

For the period from November 13, 1980 (inception) to December 31, 1981

	Number of shares of common stock	Common stock at $.01 par value	Additional paid-in capital	Total common stock and additional paid-in capital
Common stock issued on founding of the Company at $.01 per share	3,672,659	$ 36,727	—	36,727
January 1981, common stock issued to employees, scientific and financial advisers at $.01 per share	3,450,000	34,500	—	34,500
February 3, 1981, common stock issued at approximately $.51 per share	394,000	3,940	196,060	200,000
February 3, 1981, common stock issued at $.60 per share	1,333,341	13,333	786,667	800,000
March 5, 1981, common stock issued for services, valued at $.01 per share of common stock	50,000	500	—	500
May 19, 1981, common stock issued at $1.00 per share; issued 750,000 private warrants, exercisable at $1.50 per share	1,500,000	15,000	1,485,000	1,500,000
June 4, 1981, public offering at $6.00 per unit (3 shares of common stock and 3 Class A Warrants), net of commissions, underwriting expenses and other costs of $1,189,791	3,300,000	33,000	5,377,209	5,410,209
	13,700,000	137,000	7,844,936	7,981,936
Deficit accumulated during the development stage	—	—	—	(401,334)
	13,700,000	$137,000	7,844,936	7,580,602

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements
(A Development Stage Enterprise)
December 31, 1981

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The consolidated financial statements include the accounts of Genetic Systems Corporation and its wholly-owned subsidiary, Respiratory Diagnostics, Inc. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company is a development stage enterprise which intends to develop and market immunological products to be used for the diagnosis and treatment of certain human diseases. Activities to date have been primarily directed toward organizing the Company, recruiting employees and developing facilities for scientific research. Transactions from inception through December 31, 1980 were related principally to the sale of common stock and therefore have not been reported separately.

(b) Investment in Partnership

The Company's investment in Genetic Systems Respiratory Partners, a limited partnership, is stated at cost adjusted for the Company's share of undistributed earnings or loss.

(c) Leasehold Improvements, Equipment and Furniture

Owned leasehold improvements, equipment and furniture are stated at cost. Equipment and furniture under capital leases are stated at the lower of the present value of future minimum lease payments at the beginning of the lease term or fair value at the inception of the lease.

Depreciation of owned equipment and furniture and amortization of equipment and furniture under capital leases are provided on the declining balance method over the assets' estimated useful lives. Amortization of leasehold improvements is provided using the straight-line method over the lease term or the estimated useful lives, whichever is shorter.

(d) Deferred Contract Revenue

The Company generally receives cash payments in advance on research contracts. Such advance payments are deferred and recorded as revenue in the consolidated statement of operations when earned.

(e) Investment Tax Credits

Investment tax credits are recorded as a reduction of the provision for Federal income taxes in the year realized.

(f) Loss Per Average Common Share

Loss per average common share is computed using the weighted average number of common shares outstanding during the period of 10,641,303 shares. Fully-diluted earnings per share, assuming conversion of outstanding warrants, is not presented since conversion of the warrants would be anti-dilutive.

(2) Significant Agreements

(a) Pacific Northwest Research Foundation

The Company entered into a five-year research agreement, commencing March 5, 1981, with the Pacific Northwest Research Foundation (PNRF). Continuation of the agreement is subject to annual approval by both parties. Under terms of the agreement, PNRF will endeavor to produce monoclonal antibodies directed against certain specified diseases. The Company will fund this research at a base rate of $125,000 per year, with an annual escalator of 10%. In addition, PNRF received 50,000 shares of common stock valued at $.01 per share for services rendered to the Company. Monoclonal antibodies and hybridomas developed under this agreement become the property of the Company. The Company, upon marketing of monoclonal antibodies developed under the agreement, will pay royalties to PNRF ranging from 3½% to 5% of net sales. Royalties are payable on all products for a period of 20 years from the date of the first commercial sale of each such product.

(b) Fred Hutchinson Cancer Research Center

On March 5, 1981 the Company entered into an agreement with the Fred Hutchinson Cancer Research Center for commercial distribution of monoclonal antibodies. The Company has exclusive rights to produce, develop for the purpose of FDA approval, and market these antibodies in return for 8% royalties on net sales for research applications, 3% royalties on net sales for diagnostic and therapeutic purposes and, for sales of antibodies to Syva Company, the higher of the above percentages or 20% of the royalties the Company receives from Syva under the Syva agreement.

(c) Syva Company

On May 19, 1981, the Company entered into a three-year research, development and marketing agreement with Syva Company, a wholly-owned subsidiary of Syntex Corporation, for Syva to finance certain of the Company's research and development activities. Funding under this three-year agreement will be not less than $1,125,000 in the first year, $1,250,000 in the second year and $1,500,000 in the third year. At December 31, 1981, $394,438 has been received under the agreement, $117,355 of which is included in deferred contract revenue. The Company will receive a royalty of 5% of net sales of all reagents and diagnostic assays that contain reagents developed by the Company, which Syva determines are effective and is successful in marketing. The 5% royalty on each of such products will continue until the eighth anniversary after Syva has notified its domestic sales force to commence the selling effort of that product, but in no event will royalties be payable after September 15, 1996.

(d) Genetic Systems Respiratory Partners

Respiratory Diagnostics, Inc. (RDI) is one of two general partners of Genetic Systems Respiratory Partners (Partnership), a research and development limited partnership formed on December 31, 1981. RDI contributed $5,000 to the Partnership for a .5% share of allocated Partnership income or loss.

On December 31, 1981, the Company entered into a three-year research and development agreement for the Partnership to finance certain of the Company's research and development activities. The Company may receive up to approximately $3,100,000 over the term of the agreement, $133,848 of which was received on December 31 and is included in deferred contract revenue. If the Partnership fails to attain certain specified equity levels by April 15, 1982, the Company may terminate the agreement and retain all amounts received to date.

The Company has nonexclusive licenses, with an option for exclusive licenses, to market all products developed under the research and development agreement. Royalties as a percentage of net sales are 5% for nonexclusive licenses and range from 3% to 9½% for exclusive licenses.

(3) Leasehold Improvements, Equipment and Furniture

Leasehold improvements, equipment and furniture consists of the following:

Leasehold improvements	$ 804,400
Equipment	715,760
Furniture	356,732
	$1,876,892

(4) Leases

The Company entered into two 10-year leases, commencing October 1, 1981, for its laboratory and office facilities. Each lease includes an option for a 5-year extension. One lease, covering occupancy of office and initial laboratory facilities, provides for annual rentals of $297,204 plus annual adjustments for cost escalation. The lessor provided the Company with leasehold improvements amounting to $275,000, $57,040 of which is to be repaid by the Company over the term of the lease.

The second lease, covering additional laboratory facilities, provides for annual rentals of $110,811 in 1982, increasing to $143,748 in 1983 and subsequent years, plus annual adjustments for cost escalation. The lessor will provide the Company with leasehold improvements amounting to $106,250 plus a line of credit up to $200,000 for additional improvements. Draws against the line of credit will bear interest at 16% per annum and are to be repaid over 5 years, commencing one month after occupancy.

Prior to the commencement of the leases, the Company paid the lessor a $200,000 security deposit for leasehold improvements, refundable in the amounts of $50,000, $126,388 and $23,612 at the end of the first, second and tenth years of the lease, respectively. Interest accrues at 12% per annum on the amounts due after the first and second years with no interest accruing on the amount refundable in the tenth year.

Rent expense under the noncancellable leases, net of sublease rentals of $8,960, was $75,979.

Noncancellable long-term lease commitments under operating leases are as follows:

Years ending December 31	Minimum rentals	Minimum sublease rentals	Net expense
1982	$ 411,006	26,880	384,126
1983	448,938	26,880	422,058
1984	448,938	17,920	431,018
1985	448,938	—	448,938
1986	448,938	—	448,938
1987-1991	2,132,453	—	2,132,453
	$4,339,211	71,680	4,267,531

The Company sold and then leased-back certain of its equipment and furniture under two five-year leases commencing December 29, 1981. Terms of the leases require the Company to pay the purchaser-lessor at the conclusion of the lease terms on amount equal to 7% of the original cost of the equipment and furniture, at which time ownership transfers back to the Company.

Included in equipment and furniture at December 31, 1981 are the following amounts applicable to capital leases:

Equipment	$463,025
Furniture	340,435
	$803,460

Future minimum lease payments under capital leases and the present value of the net minimum lease payments as of December 31, 1981 are as follows:

Years ending December 31:	
1982	$ 213,351
1983	213,351
1984	213,351
1985	213,351
1986	251,814
Total minimum lease payments	1,105,218
Less estimated executory costs	64,945
Net minimum lease payments	1,040,273
Less amount representing interest at approximately 11.17%	253,492
Present value of net minimum lease payments included in the consolidated balance sheet as current and noncurrent obligations of $134,802 and $651,979, respectively	$ 786,781

(5) Income Taxes

The Company has loss carryforwards for both financial reporting and income tax purposes of approximately $401,000 and unused investment tax credits of $25,000 which expire in 1996.

(6) Common Stock

(a) Stock Repurchase Agreements

The Company sold 2,955,000 shares of common stock at par value to its scientific research employees under agreements which allow the Company, at its option, to repurchase all of the employee's stock at par value if employment ceases within the first year. If employment ceases in the second or third year, the Company may repurchase a prorata portion of the employee's stock based upon length of employment.

(b) Employee Stock Option Plan

The Company, subject to shareholder approval, has adopted a stock option plan pursuant to which options to purchase common stock of the Company may be granted to key employees, at an option price of not less than 100% of the fair market value of such stock on the date of the grant. At December 31, 1981, 500,000 shares of common stock were reserved for issuance under this plan. No stock options have been granted as of December 31, 1981.

(c) Warrants

On May 19, 1981, the Company issued warrants to Syntex Corporation and five other private investors, expiring in five years, for the purchase of 750,000 shares of common stock at $1.50 per share subject to adjustment under certain conditions. No warrants have been exercised at December 31, 1981.

Effective June 4, 1981, the Company executed a public offering of 1,100,000 units (3,300,000 shares) of common stock and warrants at $6.00 per unit. Each unit consisted of three shares of common stock and three Class A Warrants. The Class A Warrants entitle the holder to purchase before June 4, 1983, at a price of $3.25, one unit consisting of one share of common stock and one Class B Warrant, aggregating 3,300,000 shares of common stock and 3,300,000 Class B Warrants. Class B Warrants entitle the holders to purchase one share of common stock before June 4, 1984, at a price of $5.00. No Class A or Class B Warrants have been exercised at December 31, 1981.

Auditor's Opinion

Board of Directors
Genetic Systems Corporation:

We have examined the consolidated balance sheet of Genetic Systems Corporation and subsidiary (a Development Stage Enterprise) as of December 31, 1981, and the related consolidated statements of operations, shareholders' equity and changes in financial position for the period from November 13, 1980 (inception) to December 31, 1981. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Genetic Systems Corporation and subsidiary (a Development Stage Enterprise) at December 31, 1981, and the results of their operations and the changes in their financial position for the period November 13, 1980 (inception) to December 31, 1981, in conformity with generally accepted accounting principles.

February 9, 1982

FIRST YEAR OF ESTABLISHED OPERATING STAGE

GENETIC SYSTEMS CORPORATION
Consolidated Balance Sheets
December 31, 1982 and 1981

Assets	1982	1981
Current assets:		
Cash, including temporary cash investments of \$10,877,129 in 1982 and \$6,610,947 in 1981 (note 5)	\$11,339,555	6,655,505
Accrued interest receivable	164,986	395,894
Prepaid expenses and other current assets	281,734	88,559
Total current assets	11,786,275	7,139,958
Leasehold improvements, equipment and furniture, net of accumulated depreciation and amortization (note 4)	1,938,862	1,876,892
Other assets (note 2)	40,448	155,000
	\$13,765,585	9,171,850
Liabilities and Shareholders' Equity		
Current liabilities:		
Current installments of obligations under capital leases (note 4)	212,390	134,802
Accounts payable	334,932	553,264
Deferred contract revenue (notes 2 and 3)	1,399,003	251,203
Total current liabilities	1,946,325	939,269
Obligations under capital leases, excluding current installments (note 4)	913,507	651,979
Shareholders' equity (note 7):		
Common stock, par value \$.01 per share. Authorized 30,000,000 shares; issued 15,092,935 in 1982 and 13,700,000 in 1981	150,929	137,000
Additional paid-in capital	12,165,602	7,844,936
Accumulated deficit	(1,410,778)	(401,334)
Total shareholders' equity	10,905,753	7,580,602
Commitments (notes 3 and 4)		
	\$13,765,585	9,171,850

See accompanying notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

For the period from November 13, 1980 (inception) to December 31, 1981 and for the year ended December 31, 1982

	Number of shares of common stock	Common stock at $.01 par value	Additional paid-in capital	Accumulated deficit	Total shareholders' equity
Common stock issued on founding of the Company at $.01 per share	3,672,659	$ 36,727	—	—	36,727
January 1981, common stock issued to employees, scientific and financial advisers at $.01 per share	3,450,000	34,500	—	—	34,500
February 3, 1981, common stock issued at approximately $.51 per share	394,000	3,940	196,060	—	200,000
February 3, 1981, common stock issued at $.60 per share	1,333,341	13,333	786,667	—	800,000
March 5, 1981, common stock issued for services, valued at $.01 per share	50,000	500	—	—	500
May 19, 1981, common stock issued at $1.00 per share; issued 750,000 private warrants exercisable at $1.50 per share	1,500,000	15,000	1,485,000	—	1,500,000
June 4, 1981, public offering at $6.00 per unit (3 shares of common stock and 3 Class A Warrants), net of commissions, underwriting expenses and other costs of $1,189,791	3,300,000	33,000	5,377,209	—	5,410,209
Net loss from November 13, 1980 (inception) to December 31, 1981	—	—	—	(401,334)	(401,334)
Balance, December 31, 1981	13,700,000	137,000	7,844,936	(401,334)	7,580,602

Class A Warrants exercised at $3.25 per share, net of issuance costs of $61,193	1,317,935	13,179	4,208,916	—	4,222,095
Private Warrants exercised at $1.50 per share	75,000	750	111,750	—	112,500
Net loss for the year ended December 31, 1982	—	—	—	(1,009,444)	(1,009,444)
Balance, December 31, 1982	15,092,935	$150,929	12,165,602	(1,410,778)	10,905,753

See accompanying notes to consolidated financial statements.

Consolidated Statements of Changes in Financial Position

For the year ended December 31, 1982 and for the period from November 13, 1980 (inception) to December 31, 1981

	1982	1981
Uses of working capital:		
Net loss	$1,009,444	401,334
Items which do not use working capital:		
Amortization and depreciation	404,257	—
Share of research and development partnership expenses	62,405	—
Working capital used in operations	542,782	401,334
Purchase of leasehold improvements, equipment and furniture	466,227	1,876,892
Current installments and payments of obligations under capital leases	249,905	151,481
Increase in other assets	74,241	205,000
Increase in working capital	3,639,261	6,200,689
	$4,972,416	8,835,396
Sources of working capital:		
Decrease in other assets	126,388	50,000
Increase in obligations under capital leases	511,433	803,460
Proceeds from sale of common stock and exercise of warrants, net of issuance costs	4,334,595	7,981,936
	$4,972,416	8,835,396
Changes in components of working capital:		
Increase (decrease) in current assets:		
Cash including temporary cash investments	$4,684,050	6,655,505
Accrued interest receivable	(230,908)	395,894
Prepaid expenses and other current assets	193,175	88,559
	4,646,317	7,139,958
Increase (decrease) in current liabilities:		
Current installments of obligations under capital leases	77,588	134,802
Accounts payable	(218,332)	553,264
Deferred contract revenue	1,147,800	251,203
	1,007,056	939,269
Increase in working capital	$3,639,261	6,200,689

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

For the year ended December 31, 1982 and for the period from November 13, 1980 (inception) to December 31, 1981

	1982	1981
Contract revenue (notes 2 and 3)	$2,233,941	277,083
Expenses, principally research and development costs	3,934,209	1,410,974
Operating loss	1,700,268	1,133,891
Other income (expense):		
Interest income	872,291	732,557
Interest expense	(119,062)	—
Share of research and development partnership expenses (note 2)	(62,405)	—
Net loss	$1,009,444	401,334
Net loss per average common share outstanding	$ .07	.04

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

December 31, 1982 and 1981

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The consolidated financial statements include all accounts of Genetic Systems Corporation and its wholly-owned subsidiary, Respiratory Diagnostics, Inc. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company is engaged in development and marketing of immunological products used for the diagnosis and treatment of certain human diseases. The Company was a development stage enterprise from November 13, 1980 (inception) to December 31, 1981. Activities through December 31, 1981 were primarily directed toward organizing the Company, recruiting employees and developing facilities for scientific research. Transactions from inception through December 31, 1980 were related principally to the sale of common stock and therefore are not reported separately.

(b) Investments in Partnerships

The Company's investments in Genetic Systems Respiratory Partners (a limited partnership) and Oncogen Limited Partnership (Oncogen) are stated at cost adjusted for the Company's share of undistributed earnings or loss.

(c) Leasehold Improvements, Equipment and Furniture

Owned leasehold improvements, equipment and furniture are stated at cost. Equipment and furniture under capital leases are stated at the lower of the present value of future minimum lease payments at the beginning of the lease term or fair value at the inception of the lease.

Depreciation of owned equipment and furniture and amortization of equipment and furniture under capital leases are provided using a combination of straight-line and accelerated methods over the assets' estimated useful lives of six years. Amortization of leasehold improvements is provided using the straight-line method over the lease term or the estimated useful lives, whichever is shorter.

(d) Deferred Contract Revenue

The Company generally receives cash payments in advance on research contracts. Such advance payments are deferred and recorded as revenue in the consolidated statements of operations when earned.

(e) Investment Tax Credits

Investment tax credits will be recorded as a reduction of the provision for Federal income taxes in the year realized.

(f) Loss Per Average Common Share

Loss per average common share is computed using the weighted average number of common shares outstanding during the periods, amounting to 13,794,401 shares for the year ended December 31, 1982 and 10,641,303 for the period from November 13, 1980 (inception) to December 31, 1981. Fully-diluted earnings per share, assuming conversion of outstanding warrants, is not presented since conversion of the warrants would be anti-dilutive.

(g) Reclassifications

Certain reclassifications have been made in the 1981 consolidated financial statements to conform to the 1982 presentation.

(2) Investments in Partnerships

(a) Oncogen

In 1982 the Company entered into an agreement with Syntex Corporation (Syntex) to establish Oncogen for the purpose of developing monoclonal antibody-based products for the diagnosis and treatment of five types of human cancer.

Under the terms of the agreement, Syntex will contribute its proprietary diagnostic technology and the Company will contribute its monoclonal antibody-based technology to the Partnership. During the first four years, the partners will each contribute up to a total of $1,500,000 for leasehold improvements, equipment and other specified expenses. Additional capital will be contributed by the partners as required by the scope of the research activities. Profits and losses will be divided in proportion to the respective balances of the partners' capital accounts.

(b) Genetic Systems Respiratory Partners

Respiratory Diagnostics, Inc. (RDI) is a general partner of Genetic Systems Respiratory Partners (Partnership), a research and development limited partnership formed on December 31, 1981 to fund certain research activities of the Company.

On December 31, 1981, the Company entered into a three-year research and development agreement with the Partnership under which the Company will perform research and development activities. The Company will receive approximately $2,760,000 over the term of the agreement, of which $1,754,347 and $133,848 were received through December 31, 1982 and 1981, respectively. At December 31, 1982 and 1981, $1,259,705 and $133,848, respectively, are included in deferred contract revenue. Research performed for the Partnership resulted in 20% of the Company's contract revenues in 1982. The Company has nonexclusive licenses, with an option for exclusive licenses, to market all products developed under the research and development agreement. In return for the licenses, royalties will be paid to the Partnership based on net sales.

At December 31, 1982 and 1981, the Company's investment in the Partnership amounted to $16,836 and $5,000, respectively, and is included in other assets in the accompanying consolidated balance sheets.

(3) Research and Development Agreements

(a) Syva Company

On May 19, 1981, the Company entered into a three-year research, development and marketing agreement with Syva Company, a wholly-owned subsidiary of Syntex Corporation, for Syva to finance certain of the Company's research and development activities. The agreement, as amended, provides for funding of $1,267,228 in the first year, $1,239,720 in the second year and $1,393,052 in the third year. During 1982 and 1981, $1,113,419 and $394,438, respectively, were received under the agreement, of which $104,772 and $117,355, respectively are included in deferred contract revenue. Research performed for Syva resulted in 58% and 100% of the Company's contract revenues in 1982 and 1981, respectively. The Company will receive a royalty based on Syva's net sales of all reagents and diagnostic assays that contain reagents developed by the Company. The royalty on each of such products will continue until the eighth anniversary after Syva has notified its domestic sales force to commence the selling effort of that product, but in no event will royalties be payable after September 1996.

(b) Cutter Laboraties, Inc.

On March 31, 1982, the Company entered into an agreement with Cutter Laboratories, Inc. (Cutter), a subsidiary of Bayer AG. Under the terms of the agreement, the Company will endeavor to produce over a three-year period monoclonal antibodies directed against pseudomonas infections. Cutter will fund the project in the first year up to $350,000, and up to $600,000 in each of the next two years. The Company will fund $245,000, $305,000, and $321,000 for the first, second and third years of the agreement, respectively. During 1982, $262,500 was received and earned under the agreement, which represents 12% of the Company's contract revenue for the year.

For therapeutic products developed under the agreement, Cutter will pay to the Company royalties based on net sales for a seventeen-year period. For diagnostic products developed under the agreement, the Company will pay to Cutter royalties based on net sales for a seventeen-year period. Neither company will pay additional royalties in subsequent years.

(c) Other Agreements

The Company enters into research and license agreements in the normal course of business, providing for payment of royalties by the Company based on a percentage of sales of any products developed as a result of such research.

(4) Facilities

Leasehold improvements, equipment and furniture consist of the following:

	1982	1981
Leasehold improvements	$ 921,248	804,400
Equipment	963,436	715,760
Furniture	458,435	356,732
	2,343,119	1,876,892
Less accumulated depreciation and amortization	404,257	—
	$1,938,862	1,876,892

The Company entered into a 10-year lease, commencing October 1, 1981, for its laboratory and office facilities which includes an option for a five-year extension. Lease terms provide for annual rentals of $277,200 plus adjustments for cost escalation.

Rent expense under the above noncancellable lease was $277,372 for the year ended December 31, 1982 and $75,979 for the period from November 13, 1980 (inception) to December 31, 1981.

Noncancellable long-term lease commitments under the operating lease require a minimum rental of $277,200 and $286,160 for the years 1983 and 1984, respectively, $304,080 annually from 1985 through 1990 and $228,060 in the year 1991, aggregating $2,615,900 in total.

At December 31, 1982 and 1981, amounts included in equipment and furniture applicable to capital leases are as follows:

	1982	1981
Equipment	$ 885,579	463,025
Furniture	429,314	340,435
	$1,314,893	803,460

Future minimum lease payments under capital leases and the present value of the net minimum lease payments as of December 31, 1982 are as follows:

Years ending December 31	
1983	$ 349,485
1984	349,485
1985	349,485
1986	387,932
1987	91,097
Total minimum lease payments	1,527,484
Less estimated executory costs	100,525
Net minimum lease payments	1,426,959
Less amount representing interest at approximately 11.17%	301,062
Present value of net minimum lease payments included in the consolidated balance sheets as current and noncurrent obligations under capital leases	$1,125,897

(5) Temporary Investments

Temporary investments at December 31, 1982 include investments in United States Treasury Notes amounting to $2,800,000 recorded at cost which approximates market value.

(6) Income Taxes

At December 31, 1982, the Company had net operating loss carryforwards available to apply against future income before Federal income taxes as follows:

Year of Expiration	Financial statements	Federal income taxes
1996	$ 401,334	401,334
1997	1,009,444	871,211
	$1,410,778	1,272,545

The difference in amounts expiring in 1997 is due to differing treatment for income tax purposes of capital lease payments made in 1982.

(7) Common Stock

(a) Stock Repurchase Agreements

In 1981, the Company sold 2,955,000 shares of common stock at par value to its scientific research employees under agreements which allow the Company, at its option, to repurchase all of the employee's stock at par value if employment ceases within the first year. If employment ceases in the second or third year, the Company may repurchase a pro-rata portion of the employee's stock based upon length of employment. As of December 31, 1982, no stock had been reacquired under the repurchase agreements.

(b) Stock Option Plans

Pursuant to the Incentive Stock Option Plan adopted in 1982, 500,000 shares of common stock were reserved for granting to various executive, scientific and administrative personnel of the Company. Subsequent to December 31, 1982, the Company increased the number of shares reserved under the plan to 750,000, subject to shareholder approval. Through December 31, 1982, 314,522 options were granted at an average option price of $3.02. All options were granted at 100% of the then current market price on the date of grant and are exercisable at 20% per year over a five-year period commencing one year from the date of grant. No options were exercisable as of December 31, 1982.

In connection with the organization of Oncogen, the Company entered into employment and consulting agreements that grant nonqualified stock options for up to 210,000 shares of the Company's unregistered common stock at an option price of $2.50 per share, with an approximate market value of $4.00 per share at the date of grant. Substantially all stock options were granted to a key research scientist and are exercisable in varying amounts over a four-year period beginning in 1984.

(c) Warrants

On May 19, 1981, the Company issued warrants to Syntex Corporation and five other private investors, expiring in five years, for the purchase of 750,000 shares of common stock at $1.50 per share, subject to adjustment under certain conditions. As of December 31, 1982, 75,000 warrants had been exercised.

Effective June 4, 1981, the Company executed a public offering of 1,100,000 units of common stock and warrants at $6.00 per unit. Each unit consisted of three shares of common stock and three Class A Warrants. Each Class A Warrant entitles the holder to purchase before June 4, 1983, at a price of $3.25, one unit consisting of one share of common stock and one Class B Warrant, aggregating 3,300,000 shares of common stock and 3,300,000 Class B Warrants. Each Class B Warrant entitles the holder to purchase one share of common stock before June 4, 1984, at a price of $5.00. At December 31, 1982, 1,317,935 Class A Warrants had been exercised, resulting in the issuance of an equivalent number of Class B Warrants. At December 31, 1982, no Class B Warrants had been exercised.

In connection with the public offering, the Company sold to an underwriter, for $100, a Unit Purchase Option (Option) to purchase 100,000 units, each consisting of three shares of common stock and three Class A Warrants. The Option is exercisable over a four-year period, commencing January 4, 1982, at $7.20 per unit. At December 31, 1982, the Option had not been exercised.

(8) Supplementary Income Statement Information

The Company incurred $113,630 and $34,420 of advertising costs and $50,187 and $6,957 of tax expense, excluding payroll taxes, in 1982 and 1981, respectively.

Auditor's Opinion

Board of Directors
Genetic Systems Corporation:

We have examined the consolidated balance sheets of Genetic Systems Corporation and subsidiary as of December 31, 1982 and 1981 and the related consolidated statements of operations, shareholders' equity and changes in financial position for the year ended December 31, 1982 and for the period from November 13, 1980 (inception) to December 31, 1981. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Genetic Systems Corporation and subsidiary at December 31, 1982 and 1981, and the results of their operations and the changes in their financial position for the year ended December 31, 1982 and for the period from November 13, 1980 (inception) to December 31, 1981, in conformity with generally accepted accounting principles applied on a consistent basis.

February 25, 1983

APPENDIX

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 7 ACCOUNTING AND REPORTING BY DEVELOPMENT STAGE ENTERPRISES

JUNE 1975

INTRODUCTION

1. This Statement specifies the guidelines for identifying an enterprise in the development stage and the standards of financial accounting and reporting applicable to such an enterprise. The transition requirements of this Statement are also applicable to certain established operating enterprises.[1]

2. Some development stage enterprises have adopted special financial accounting and reporting practices, including special forms of financial statement presentation or types of disclosure, that are different from those used by established operating enterprises. Some of the special practices have resulted from applying regulations of the Securities and Exchange Commission; other practices appear simply to have evolved. Special accounting practices have included (a) deferral of all types of costs without regard to their recoverability, (b) nonassignment of dollar amounts to shares of stock issued for consideration other than cash, and (c) offset of revenue against deferred costs. Special reporting formats have included statements of (a) assets and unrecovered preoperating costs, (b) liabilities, (c) capital shares, and (d) cash receipts and disbursements. Sometimes, a balance sheet or a statement of operations is presented in conjunction with one or more special formats. Other development stage enterprises issue financial statements like those of established operating enterprises that present financial position, changes in financial position, and results of operations in conformity with generally accepted accounting principles.

3. No special standards of financial accounting and reporting were established for development stage enterprises by the

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[1]See paragraphs 14-16.

AICPA Accounting Principles Board or its predecessor, the Committee on Accounting Procedure. In 1973, the AICPA Committee on Companies in the Development Stage issued an exposure draft of a proposed Audit Guide recommending special financial statements and accounting methods, but no action was taken on the exposure draft and the matter was referred to the FASB. *FASB Statement No. 2*, "Accounting for Research and Development Costs," issued in October 1974, has been interpreted by the FASB to apply to "the accounting for research and development costs of development stage enterprises whose financial statements present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles."[2] However, pending the issuance of a Statement on the subject of accounting and reporting by development stage enterprises, the FASB Interpretation stated that "a development stage enterprise that issues financial statements that do not purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles need not apply *Statement No. 2* in accounting for its research and development costs."[3]

4. The standards of financial accounting and reporting set forth in this Statement apply to any separate financial statements of a development stage subsidiary or other investee[4] of an established operating enterprise, as well as to the financial statements of a separate development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage). Hereinafter, the term "development stage enterprise" is used to include a development stage subsidiary or other investee that is issuing separate financial statements.

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[2]*FASB Interpretation No. 5*, "Applicability of FASB Statement No. 2 to Development Stage Enterprises," para. 6.

[3]*Ibid.*, para. 7.

[4]The terms *subsidiary* and *investee* are defined in paragraph 3 of *APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock."

5. This Statement applies to development stage enterprises in all industries. This Statement applies to development stage enterprises in regulated industries in accordance with the provisions of the Addendum to *APB Opinion No. 2*, "Accounting for the 'Investment Credit.'" However, paragraphs 11-12 of this Statement, which require disclosure of additional information, apply to development stage enterprises in regulated industries in all cases.

6. This Statement supersedes *FASB Interpretation No. 5*, "Applicability of FASB Statement No. 2 to Development Stage Enterprises." It does not supersede, alter, or amend any other present requirement in an Accounting Research Bulletin (ARB), Accounting Principles Board (APB) Opinion, or FASB Statement or Interpretation. Neither does this Statement change generally accepted accounting principles that are currently applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation. For example, this Statement does not change generally accepted accounting principles applicable to (a) established operating enterprises generally in expanding their existing businesses, (b) established operating enterprises in the extractive industries in their exploration and development activities, and (c) established operating enterprises in the real estate industry in developing their properties.

7. Standards of financial accounting and reporting for development stage enterprises are set forth in paragraphs 8-16. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others. Appendix A provides background information.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Guidelines for Identifying a Development Stage Enterprise

8. For purposes of this Statement, an enterprise shall be considered to be in the development stage if it is devoting

substantially all of its efforts to establishing a new business and either of the following conditions exists:

a) Planned principal operations have not commenced.

b) Planned principal operations have commenced, but there has been no significant revenue therefrom.

9. A development stage enterprise will typically be devoting most of its efforts to activities such as financial planning; raising capital; exploring for natural resources; developing natural resources; research and development;[5] establishing sources of supply; acquiring property, plant, equipment, or other operating assets, such as mineral rights; recruiting and training personnel; developing markets; and starting up production.

Financial Accounting and Reporting

10. Financial statements issued by a development stage enterprise shall present financial position, changes in financial position, and results of operations in conformity with the generally accepted accounting principles that apply to established operating enterprises and shall include the additional information required by paragraphs 11-12. Special accounting practices and reporting formats, such as those described in paragraph 2 of this Statement, that are based on a distinctive accounting for development stage enterprises are no longer acceptable. Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise. For a

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[5]*Research and development* is defined in paragraph 8 of *FASB Statement No. 2*, "Accounting for Research and Development Costs."

development stage subsidiary or other investee, the recoverability of costs shall be assessed within the entity for which separate financial statements are being presented.

11. In issuing the same basic financial statements as an established operating enterprise, a development stage enterprise shall disclose therein certain additional information. The basic financial statements to be presented[6] and the additional information shall include the following:

a) A balance sheet, including any cumulative net losses reported with a descriptive caption such as "deficit accumulated during the development stage" in the stockholders' equity section.

b) An income statement, showing amounts of revenue and expenses for each period covered by the income statement and, in addition, cumulative amounts from the enterprise's inception.[7]

c) A statement of changes in financial position, showing the sources and uses of financial resources for each period for which an income statement is presented[8] and, in addition, cumulative amounts from the enterprise's inception.

d) A statement of stockholders' equity, showing from the enterprise's inception:[9]

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[6]Under some circumstances, an established operating enterprise may issue less than a full set of financial statements, for example, only a balance sheet. This Statement does not preclude that possibility for development stage enterprises. Also, different titles or formats used by some established operating enterprises may be used provided that the prescribed information is included.

[7]For a dormant enterprise that is reactivated to undertake development stage activities, the disclosure of cumulative amounts required by this paragraph shall be from inception of the development stage.

[8]Subject to the exceptions described in paragraphs 7 and 16 of *APB Opinion No. 19*, "Reporting Changes in Financial Position."

[9]Separate issuances of equity securities within the same fiscal year for the same type of consideration and for the same amount per equity

1) For each issuance, the date and number of shares of stock, warrants, rights, or other equity securities issued for cash and for other consideration.

2) For each issuance, the dollar amounts (per share or other equity unit and in total) assigned to the consideration received for shares of stock, warrants, rights, or other equity securities. Dollar amounts shall be assigned to any noncash consideration received.

3) For each issuance involving noncash consideration, the nature of the noncash consideration and the basis for assigning amounts.

12. The financial statements shall be identified as those of a development stage enterprise and shall include a description of the nature of the development stage activities in which the enterprise is engaged.

13. The financial statements for the first fiscal year in which an enterprise is no longer considered to be in the development stage shall disclose that in prior years it had been in the development stage. If financial statements for prior years are presented for comparative purposes, the cumulative amounts and other additional disclosures required by paragraphs 11-12 need not be shown.

Effective Date and Transition

14. This Statement shall be effective for fiscal periods beginning on or after January 1, 1976, although earlier application is encouraged. Thereafter, when financial statements, or financial summaries or other data derived

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unit may be combined in the statement of stockholders' equity. Appropriate modification of the statement of stockholders' equity may be required for (a) a combined group of companies that, as a whole, is considered to be in the development stage and (b) an unincorporated development stage enterprise.

therefrom, are presented for periods prior to the effective date of this Statement, they shall be restated, where necessary, to conform to the provisions of this Statement. Accordingly, any items that would have been accounted for differently by a development stage enterprise if the provisions of paragraph 10 had then been applicable shall be accounted for by prior period adjustment (described in paragraphs 18 and 26 of *APB Opinion No. 9,* "Reporting the Results of Operations").

15. An established operating enterprise that during its development stage would have accounted for any items differently if the provisions of paragraph 10 had then been applicable shall account for those items by prior period adjustment. In some cases, those items will have been amortized or otherwise included in an income statement in periods prior to the effective date of this Statement. Financial statements, or financial summaries or other data derived therefrom, for those periods shall be restated when they are included for comparative purposes with financial data for periods after the effective date of this Statement.

16. The nature of any adjustment or restatement resulting from application of paragraphs 14-15 and, where appropriate, its effect on income before extraordinary items, net income, and related per share amounts shall be disclosed in the period of change for all periods presented. Any related income tax effects shall be recognized and disclosed.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Schuetze dissented.

Although he agrees with the basic conclusions in this Statement that development stage enterprises should use the same accounting principles and prepare the same basic financial statements as established operating enterprises, Mr. Schuetze dissents because he believes that the Board should have addressed the question of accounting for start-up costs before issuing this Statement. Paragraph 10 states that "capitalization or deferral of costs [in a development stage enterprise] shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise." A substantial portion of the costs incurred by many development stage enterprises falls into a broad category that most persons would regard as start-up costs. In Mr. Schuetze's view, neither this Statement nor any other authoritative pronouncement furnishes adequate guidance as to how the recoverability of start-up costs should be assessed or as to how those start-up costs that are capitalized or deferred should be accounted for thereafter. Mr. Schuetze believes that until such a pronouncement is issued the accounting practices of development stage enterprises will vary significantly. In this regard, Mr. Schuetze is particularly concerned as to how the recoverability test in paragraph 10 would be applied by development stage enterprises in the extractive industries.

Members of the Financial Accounting Standards Board:

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke
Robert E. Mays
Walter Schuetze
Robert T. Sprouse

Appendix A

BACKGROUND INFORMATION

17. In April 1973, the FASB placed on its technical agenda a project on "Accounting for Research and Development and Similar Costs." The scope of the project also encompassed accounting and reporting by development stage enterprises, the subject of this Statement.

18. A task force of sixteen persons from industry, government, public accounting, the financial community, and academe was appointed in July 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

19. The FASB did not undertake a major research effort in connection with the project but rather relied primarily on published research studies and articles that are cited in the Discussion Memorandum. Especially important in this regard was *Accounting for Companies in the Development Stage*, an exposure draft of an Audit Guide originally issued for comment in 1973 by the Committee on Companies in the Development Stage of the American Institute of Certified Public Accountants.

20. The Discussion Memorandum was issued by the Board on December 28, 1973, and a public hearing on the subject was held on March 15, 1974. Seventy-four position papers, letters of comment, and outlines of oral presentations were received by the Board in response to the Discussion Memorandum. Thirty-nine of those responses included recommendations about development stage enterprises. Fourteen oral presentations were made at the public hearing.

21. In the course of its deliberations following the hearing, the Board concluded that accounting and reporting by development stage enterprises should be addressed in a separate Statement of Financial Accounting Standards. An Exposure Draft of a proposed Statement on "Accounting and

Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components" was issued on July 19, 1974. The Board received 138 letters of comment on the Exposure Draft. In November 1974, the Board announced that "because of questions raised in many of the comment letters received during exposure of the proposed Statement on development stage companies, the Standards Board is continuing its consideration of that subject and a final Statement is not expected to be issued before April or May of 1975."[10]

[10] *FASB Status Report*, No. 19, November 16, 1974.

Appendix B

BASIS FOR CONCLUSIONS

22. This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

23. As indicated by the title, the Exposure Draft, "Accounting and Reporting by Development Stage Companies, Subsidiaries, Divisions and Other Components," explicitly encompassed a development stage subsidiary, division, or other component of an established operating enterprise as well as a separate development stage enterprise. A number of respondents to the Exposure Draft interpreted the inclusion of subsidiaries, divisions, or other components of an established operating enterprise to mean that new financial accounting standards were being proposed for the costs incurred by established operating enterprises in expanding their existing businesses. Those respondents suggested that any changes called for by the proposed new standards in that regard were unclear. They further suggested that the proposed new standards for financial statement presentation and disclosure were inapplicable to components of established operating enterprises except as they might apply to separate financial statements occasionally issued by subsidiaries in the development stage.

24. In addition to accounting for research and development costs and accounting for development stage enterprises, the Discussion Memorandum comprehended accounting for start-up costs and other costs that are similar to research and development costs in the sense that they share certain distinguishing characteristics.[11] In issuing the Exposure

[11] *FASB Discussion Memorandum*, "Accounting for Research and Development and Similar Costs," pp. 2-5.

Draft, however, the Board did not intend to propose new financial accounting standards for start-up costs and those other "similar costs" incurred by established operating enterprises. To eliminate that possible source of confusion and to deal more directly with the financial accounting and reporting matters affecting development stage enterprises, the scope of this Statement is restricted to the financial statements of a development stage enterprise (or of a group of companies that, as a whole, is considered to be in the development stage) and to any separate financial statements of a development stage subsidiary or other investee of an established operating enterprise (see paragraph 4).

Development Stage Enterprises in the Extractive Industries

25. A number of respondents to the Exposure Draft questioned the application of this Statement to development stage enterprises in certain industries (see paragraph 5 of this Statement), especially to development stage enterprises in the extractive industries. The Discussion Memorandum made a distinction for the extractive industries between (1) costs that are indistinguishable in nature from those costs incurred in other industries and (2) costs that are incurred uniquely in the extractive industries. It stated that "research and development and similar costs that are indistinguishable in nature from the research and development and similar costs incurred in other industries are embraced by this project." The Discussion Memorandum also stated that costs that are incurred uniquely in the extractive industries are generally believed to warrant separate consideration and "are specifically outside the scope of this project."[12] *FASB Statement No. 2*, "Accounting for Research and Development Costs," in paragraph 3, recognized that distinction by indicating that it "does not apply to activities that are unique to enterprises in the extractive industries."

26. Chapter four, "Companies in the Development Stage," of the Discussion Memorandum states that "this Discussion

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[12] *Ibid.*, pp. 8-9.

Memorandum excludes from this project only those 'costs that are incurred uniquely in the extractive industries.' Therefore, whether extractive industry companies in the development stage have sufficiently different characteristics to warrant exclusion from or special handling in a definition of a company in the development stage requires consideration."[13]

27. The AICPA Committee on Companies in the Development Stage indicated in its 1973 exposure draft that the proposed provisions should be applicable to any development stage enterprise in any industry. Similarly, the APB Committee on Extractive Industries states, "new companies still in the exploratory and development stage in the oil and gas industry are no different than companies in a similar stage in other industries and probably should not be afforded any special treatment."[14]

28. The Board has concluded that consideration of the accounting for costs incurred in activities that are unique to enterprises in the extractive industries is outside the scope of this Statement. Paragraph 6 explains that this Statement does not change generally accepted accounting principles that are applicable to established operating enterprises but that are not explicitly stated in an ARB, APB Opinion, or FASB Statement or Interpretation, and cites as an example generally accepted accounting principles that are applicable to established operating enterprises in the extractive industries in their exploration and development activities. The effect of this Statement being applicable to development stage enterprises in all industries, therefore, is not to change the generally accepted accounting principles applicable to costs incurred in activities that are unique to enterprises in the extractive industries, but to require those generally

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[13] *Ibid.*, p. 55.

[14] American Institute of Certified Public Accountants, Accounting Principles Board Committee on Extractive Industries, *Accounting and Reporting Practices in the Oil and Gas Industry* (New York: AICPA, May 31, 1973), p. 24.

accepted accounting principles applicable to established operating enterprises in the extractive industries to be applied to development stage enterprises in the extractive industries as well. This includes presentation of the same basic financial statements.

GUIDELINES FOR IDENTIFYING A DEVELOPMENT STAGE ENTERPRISE

29. The broad guidelines set forth in paragraphs 8-9 for identifying a development stage enterprise are designed to include enterprises engaged in diverse areas of economic activity. The point at which an enterprise ceases to be in the development stage, and, therefore, need not present the cumulative amounts since its inception and other additional disclosures required by paragraphs 11-12, must be evaluated in each case.

ACCOUNTING

30. The Board has concluded that the generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. The primary reasons for this conclusion are:

a) The kinds of transactions engaged in by development stage enterprises are also common to established operating enterprises in expanding their existing businesses. Accounting treatment should be governed by the nature of the transaction rather than by the degree of maturity of the enterprise. Thus, the determination of whether a particular cost should be charged to expense when incurred or should be capitalized or deferred should be based on the same accounting standards regardless of whether the enterprise incurring the cost is already operating or is in the development stage.

b) Any different standards for a development stage enterprise that would result in deferral of costs that would not be deferred if the generally accepted accounting principles applicable to established operating enterprises had been applied may cause financial statement users to reach unjustified conclusions about the nature of the costs incurred by a development stage enterprise. The Board believes that adequate financial statement disclosures concerning the costs incurred by a development stage enterprise, both for the current period and cumulatively since its inception, will mitigate that possibility and provide useful financial information for decisions about that kind of enterprise.

31. Established operating enterprises incur costs under various circumstances and with varying degrees of uncertainty about future benefits, especially in expanding their existing businesses. Authoritative accounting literature does not contain general criteria or guidelines for determining when costs should be charged to expense as incurred and when costs should be capitalized or deferred,[15] and this Statement does not attempt to specify such criteria or guidelines.

32. The absence of explicit criteria or guidelines, however, does not provide a free choice to defer costs or to charge them to expense when incurred. The scope of generally accepted accounting principles is broader than the

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[15]Guidance is provided for some specific situations. For example, *FASB Statement No. 2* prescribes that the research and development costs encompassed by that Statement shall be charged to expense when incurred and describes the considerations that led to that conclusion. Also, AICPA Industry Audit Guides provide guidance about accounting for costs incurred by enterprises in particular industries. Although Audit Guides do not constitute authoritative accounting literature, those issued in recent years state that members of the AICPA may be called upon to justify departures from the recommendations contained therein.

authoritative literature and encompasses practices that have evolved and gained acceptance with time and experience. Many of those practices are described in *APB Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises." For example, paragraph 160 of *APB Statement No. 4* describes generally accepted accounting principles as calling for immediate recognition as expense when "(1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose."[16]

33. In concluding that the generally accepted accounting principles applicable to established operating enterprises shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred, the Board is relying primarily on the assessment of recoverability of incurred costs that those principles require. Heretofore, some have felt that generally accepted accounting principles did not apply to the special accounting practices and special financial reporting formats that have been used by some development stage enterprises. The Board's conclusion that the generally accepted accounting principles applicable to established operating enterprises also apply to development stage enterprises, including presentation of the same basic financial statements, eliminates the special practices and formats and the question about the applicability of generally accepted accounting principles to them.

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[16] *APB Statement No. 4*, in paragraph 4, describes its status as follows: "The accounting principles described are those that the [Accounting Principles] Board believes are generally accepted today. The Board has not evaluated or approved present generally accepted accounting principles except to the extent that principles have been adopted in Board Opinions. Publication of this Statement does not constitute approval by the Board of accounting principles that are not covered in its Opinions."

SEC Regulations and AICPA Committee Proposal

34. Both the regulations of the Securities and Exchange Commission (SEC) and the proposed Audit Guide issued by the AICPA Committee on Companies in the Development Stage provide for the use by development stage enterprises of certain accounting practices that differ from those appropriate for established operating enterprises.

35. Article 5A of SEC *Regulation S-X* prescribes the form and content of financial statements filed with the SEC by development stage enterprises. It provides for separate statements of (a) assets and unrecovered promotional, exploratory, and development costs; (b) liabilities; (c) capital shares; (d) other securities; and (e) cash receipts and disbursements. Among the types of costs indicated as includible in *unrecovered promotional, exploratory, and development costs* are:

> (a) development expenses, (b) plant and equipment maintenance expenses, (c) rehabilitation expenses, (d) general administrative expenses incurred in a period when there was little or no actual mining and (e) other expenses. . . . General administrative expenses incurred in connection with subcaptions (a), (b) and (c) should be included therein. Any other general administrative expenses not chargeable to those subcaptions nor written off as costs or other operating charges (including taxes, protection and conservation of property when inactive) shall be included under subcaption (d).[17]

Rule 12-06a of *Regulation S-X* allows for the offset of certain proceeds and other income against promotional, exploratory, and development costs.

36. The AICPA Committee proposed the presentation of cumulative cost outlays, together with assets, liabilities, and

[17]U.S., Securities and Exchange Commission, *Regulation S-X*, Rule 5a-02, "Statement of Assets and Unrecovered Promotional, Exploratory, and Development Costs," item 14.

investment by stockholders, in a special statement referred to as a "preoperating accountability statement." Cumulative cost outlays would have been deferred and amortized by charges against income when operations commenced. Incidental revenue received during the development stage would have been deducted from the cumulative cost outlays.

37. The AICPA Committee stated the basis for its conclusion as follows:

> A company in the development stage is engaged in building an enterprise, and the expenditures it makes are in the nature of investments for the future. Costs incurred during the development stage are accumulated because they have been incurred in the expectation that they will generate future revenues or otherwise benefit periods after the company reaches the operating stage. Accumulating costs is consistent with the business fact that for many companies a development stage must precede the attainment of ordinary business operations. . . . The only outlays that should not be carried as accumulated costs during the preoperating period are those relating to known losses. . . .
>
> For a company in the development stage there is from inception a presumption that uncertainty as to cost recovery will both exist and persist. (By contrast, the presumption for an operating company is that cost recoverability can be reasonably evaluated.) It would be unrealistic and arbitrary to write off immediately the costs incurred during the development stage simply because of this predictable uncertainty.[18]

38. Both the SEC and AICPA Committee approaches draw attention to the uncertainty about cost recovery surrounding most development stage costs by segregating them in a special category in a special financial statement (or group of statements) similar to the conventional balance sheet. Those

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[18]American Institute of Certified Public Accountants, Committee on Companies in the Development Stage, *Accounting for Companies in the Development Stage*, an exposure draft of an Audit Guide (New York: AICPA, March 1973), pp. 25-26, 28.

costs are not reported as "assets," and they need not be subjected to the assessment of recoverability that is applied to costs incurred by established operating enterprises. The Board believes, however, that the distinction between costs that would be reported as "assets" and costs that would be reported as "unrecovered costs" or "cumulative cost outlays" under the SEC and AICPA Committee approaches is one that is likely to be overlooked by many financial statement users. In addition, as indicated in paragraphs 30-33, the Board believes that all costs of a development stage enterprise should be subjected to the same assessment of recoverability applicable to costs incurred by established operating enterprises. In the Board's view, the nature of development stage activities and their related costs can best be indicated by the additional financial statement disclosures required by paragraphs 11-12, rather than by accumulation or deferral of costs that would be charged to expense when incurred if generally accepted accounting principles applicable to established operating enterprises were applied.

39. Accumulation or deferral of development stage costs requires amortization after operations commence. Article 5A does not address the question of amortization, and the AICPA Committee noted that "while the current practices are anything but uniform, the most prevalent policy noted is to amortize such costs over a short period of time, usually not more than five years."[19] The Board believes that the difficulty in reasonably relating subsequent revenue to accumulated or deferred costs that would not be deferred under generally accepted accounting principles applicable to established operating enterprises limits the usefulness of the data that would result from such accumulation or deferral by a development stage enterprise. Moreover, the initial operating periods of such an enterprise would include both the amortization of those costs incurred during the development stage and the charging to expense of certain costs incurred currently.

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[19] *Ibid.*, p. 11.

40. Some respondents to the Discussion Memorandum and to the Exposure Draft supported the SEC approach, the proposed approach of the AICPA Committee, or similar approaches. The reasons offered were generally similar to those stated by the AICPA Committee (see paragraph 37). A number of respondents to the Discussion Memorandum and to the Exposure Draft recommended that development stage enterprises follow the same accounting standards as established operating enterprises. The reasons given by the respondents were generally similar to those specified in paragraph 30.

Relationship to "Similar Costs"

41. The Exposure Draft stated that the Board was considering an additional pronouncement on the "similar costs" identified in the Discussion Memorandum. A number of respondents to the Exposure Draft indicated that because, in their view, many costs incurred by development stage enterprises are within a broader category of costs that include start-up costs generally, the Board should address accounting for those "similar costs" before issuing a final Statement on development stage enterprises. The Board considered those suggestions, but concluded that it could reach an informed decision on the issues covered in this Statement without first addressing the more pervasive issues associated with accounting for "similar costs." In the Board's view, this Statement will significantly improve financial accounting and reporting for development stage enterprises.

FINANCIAL STATEMENT PRESENTATION AND ADDITIONAL DISCLOSURES

42. The Board believes that a development stage enterprise should present the same basic financial statements as any other enterprise. The conventional balance sheet, income statement, statement of changes in financial position, and statement of stockholders' equity are sufficiently adaptable to provide the distinctive information that might be considered useful for development stage enterprises. Unique

financial statements for development stage enterprises might imply that the nature and results of the transactions entered into by those enterprises are unique, but many established operating enterprises have similar transactions. Further, unique financial statements would not be readily comparable with financial statements issued after an enterprise has emerged from the development stage. Also, the conclusion that the same accounting principles are appropriate for the transactions of development stage enterprises suggests that conventional basic financial statements should be presented.

43. A development stage enterprise typically will be incurring substantial costs in connection with development stage activities and will not have significant revenue. Development stage activities are likely to extend into two or more financial reporting periods. To reflect the significance of development stage activities, the Board believes that the basic financial statements presented by a development stage enterprise should be expanded to provide cumulative financial information since its inception, as well as current information. The Board concluded that disclosure of cumulative revenue and expenses and cumulative amounts of funds obtained from various sources to finance the development effort and initial operations will provide useful information about the activities of development stage enterprises without sacrificing the advantages of retaining the familiar format and content of the basic financial statements of established operating enterprises. Those additional disclosures are specified in paragraphs 11-12.

44. Some respondents to the Discussion Memorandum and Exposure Draft suggested that the differences between established operating enterprises and development stage enterprises are so fundamental as to require unique financial statements for development stage enterprises. The AICPA Committee concluded that, because of the absence of revenue, a conventional income statement would be inappropriate for a development stage enterprise; unique financial statements were deemed necessary to emphasize accountability for financial resources received and expended and to direct attention to accumulated costs rather than to

measurement of performance. To accomplish those objectives, the Committee recommended the following special statements:

Preoperating accountability statement — to show the assets and cumulative cost outlays, the liabilities, and the investment by stockholders.

Statement of preoperating financial activities — to show the sources and uses of financial resources, preferably cumulative since an enterprise's inception along with data for the current period.

Statement of investment by stockholders — to show the classes and numbers of shares authorized, issued, and outstanding and the types and amounts of consideration received for the shares issued.

45. The AICPA Committee proposed extensive disclosures emphasizing that the enterprise is in the development stage, calling attention to the uncertainties that surround the enterprise and making clear that the financial statements do not purport to present financial position and results of operations.

46. Other respondents to the Discussion Memorandum and to the Exposure Draft took the position that different basic financial statements or additional disclosures are not necessary for a development stage enterprise. Still others asserted that the same basic financial statements are appropriate but should be supplemented by additional disclosures relevant to the distinctive features of a development stage enterprise.

Other Suggestions

47. The Board considered other presentation and disclosure possibilities for a development stage enterprise (including forecasts, disclosure of liquidation priorities and values, and a description of the business environment) and concluded that they should not be required solely for development stage

enterprises. The Board also considered the possibility of a statement of cash receipts and disbursements and concluded that the statement of changes in financial position including amounts on a cumulative basis required by paragraph 11(c) would fulfill that need.

POTENTIAL ECONOMIC IMPACT

48. Some respondents to the Exposure Draft expressed concern that requiring development stage enterprises to present the same basic financial statements and to apply the same generally accepted accounting principles as established operating enterprises might make it difficult, if not impossible, for development stage enterprises to obtain capital. They suggested that those requirements would likely cause many development stage enterprises to report periodic losses in an income statement and a cumulative deficit in a balance sheet. Because those results would not be fully understood, suppliers of capital would be disinclined to invest in those enterprises.

49. During the course of developing the Discussion Memorandum and preparing the Exposure Draft, the FASB solicited information about the potential economic impact of applying to development stage enterprises the same generally accepted accounting principles that apply to established operating enterprises. Responses of financial statement users to the Discussion Memorandum and to the Exposure Draft provided only limited information about the potential economic impact. To obtain additional information, the FASB arranged for discussions with officers of fifteen venture capital enterprises. The consensus of those officers was that whether a development stage enterprise defers or expenses preoperating costs has little effect on (a) the amount of any venture capital to be provided to that enterprise and (b) the terms under which any venture capital is provided. According to those officers, the venture capital investor typically relies on an investigation of the technological, marketing, management, and financial aspects of an enterprise. That investigation provides a basis for estimating potential cash

flows and the probabilities of achieving them. Whether a development stage enterprise defers or expenses its preoperating costs does not affect those estimates. Based on their experience, those officers also expressed the opinion that the accounting treatment of preoperating costs would have minimal impact on the availability of short-term credit from commercial banks, but might have impact on the investment and credit decisions of unsophisticated investors.

50. In January 1975, the U.S. Department of Commerce issued a report of a study entitled "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms." The study involved interviews with forty lenders and investors, eleven small, high-technology firms, eleven accountants, and selected government agencies. It focused primarily on the impact on investment and credit decisions concerning development stage enterprises if they were required to charge research and development costs to expense when incurred. That issue is related to the issue at hand — that is, the potential economic impact on development stage enterprises of requiring certain costs to be expensed when incurred rather than deferred. The conclusions of the Department of Commerce study were generally consistent with the FASB findings described in paragraph 49 of this Statement. Specifically, the study concluded that "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R&D."[20]

51. In summary, the Board has concluded that the cumulative income statement information and the cumulative information about changes in financial position required in paragraph 11 of this Statement will provide the cumulative information about preoperating costs that is typically provided by development stage enterprises currently when

[20]U.S., Department of Commerce, "Impact of FASB's Rule Two Accounting for Research and Development Costs on Small/Developing Stage Firms" (Washington, D.C.: U.S., Department of Commerce, January 20, 1975), p. 3.

using special reporting formats and special accounting practices, such as those cited in paragraph 2. In addition, this Statement requires such information to be presented in financial statements whose formats are familiar and, therefore, less likely to be misinterpreted. As for the concerns of some respondents, the results of FASB discussions and the Department of Commerce study suggest that this Statement will have no significant adverse effect on the ability of development stage enterprises to obtain capital.

ISSUANCE OF SHARES OF STOCK OTHER THAN FOR CASH

52. Under the provisions of Article 5A of SEC *Regulation S-X*, dollar amounts are not assigned to shares of stock issued by a development stage enterprise for noncash consideration, or to the consideration received, unless the noncash consideration has a "fixed or objectively determinable value."

53. The proposed AICPA Audit Guide would have required assignment of dollar amounts to shares of stock issued for noncash consideration, and to the consideration received, at the time of issuance.

54. The Board agrees with the conclusion of the AICPA Committee, and of a number of respondents to the Discussion Memorandum and Exposure Draft who addressed this question, that those transactions should be accounted for when the shares are issued in accordance with the guidelines applicable to acquisition of assets or issuance of shares in general. The transactions are not unique to development stage enterprises and should not be accounted for differently by those enterprises, even if estimates and judgments are required to determine their values.

EFFECTIVE DATE AND TRANSITION

55. The Board adopted the restatement provisions set forth in paragraphs 14-16 because, in its view, this approach

provides the most useful information about development stage enterprises and about those previously in the development stage in comparing financial data for periods after the effective date of this Statement with data presented for earlier periods.

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